the Budget

Tabled in the House of Commons by

the Honourable Michael H. Wilson

Minister of Finance

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CHAPTER 1: THE BUDGET SPEECH

My previous budgets have introduced a wide range of fundamental economic and fiscal reforms. Today, I will propose further far-reaching initiatives.

Our policies have been challenging for Canadians and for the government. But they are essential to help our country manage the risks and seize the opportunities of a rapidly changing economic world.

The world economy continues to grow more fiercely competitive. A relentless tide of economic change is having profound effects on people, industries and countries. While the opportunities have increased, so have the risks.

Since my last budget, rising uncertainty has taken a heavy toll on both economic confidence and performance in Canada and around the world.

- We have seen international stability shaken by military hostilities in the Persian Gulf and by political upheaval in Eastern Europe and the Soviet Union.
- Vital negotiations to open up world trade have encountered serious problems, posing large risks to Canada's trade-oriented economy.
- As in a number of other countries including the United States, our economy is now in recession. Many Canadians have lost their jobs; many others have lost confidence in the economic future.
- And this is happening at a time when some are questioning the future of Canada itself.

And yet, we must deal with the world as it is, and not as we might wish it to be.

Toward recovery

In difficult times, it is easy to lose perspective as well as confidence. But it is times like this when a clear, realistic perspective is most needed to rebuild confidence and to chart a sound, sensible course of recovery.

We must not lose sight of the fact that a strong foundation exists for optimism as we face the major challenges that lie ahead.

- Internationally, the vast majority of countries continue to express their powerful, common interest in maintaining a stable world order and in developing more reliable and open economic relationships.
- We are a resilient, resourceful country. A stronger, more confident Canada is well within our reach, if we are prepared to work for it.
- During the past year, we have made encouraging progress in reducing both inflationary pressures and interest rates. As a result, the prospects are hopeful for an economic recovery beginning in the second half of this year.

But we must also recognize that hope alone will not be enough.

A time for action

This time of uncertainty and risk is also a time for action, at home and abroad, to solve our problems and restore confidence in our future.

Abroad, Canada will continue to play its part in co-operative efforts to provide greater stability in political and economic affairs. As a vital part of this responsibility, we will continue to support the United Nations' effort to restore peace and order in the Persian Gulf. We must and we will provide the men and women of our armed forces with all the support they need to complete this task. We must also be prepared to play a constructive role in the area after hostilities end.

Here at home, we must take further decisive action to move our economy toward early recovery and sustained growth.

RECOVERY, GROWTH AND PROSPERITY

This budget sets out a Plan for Economic Recovery – a strong, confident recovery that not only puts the recession behind us but leads us forward to continuing growth and renewed prosperity.

Our priority is action to create the essential conditions for recovery. Ours is not a plan for increased spending. That approach has been tried in the past and failed. The key to recovery is lower interest rates. The Plan for Economic Recovery will bring about lower interest rates through the following actions:

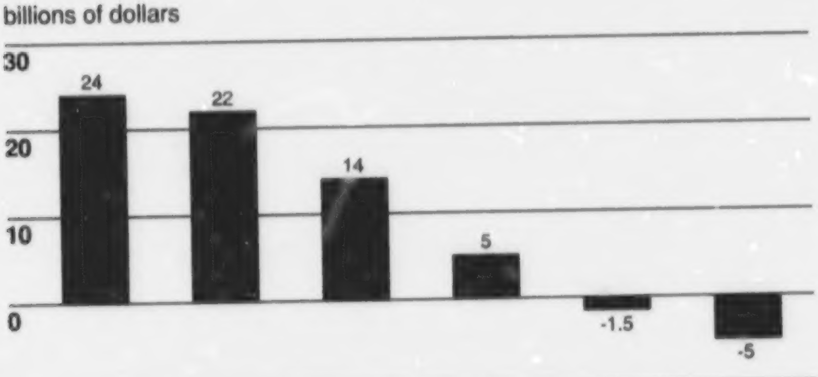
- **We will set out clear, achievable inflation targets**. Inflation will be reduced to 2 per cent by mid-decade. The result of lower inflation and lower expectations for inflation will be lower interest rates.
- **We will put government finances firmly on the course to a balanced budget**. We will remove the build-up of the public debt as a source of inflationary concern.
  - The Expenditure Control Plan announced in the 1990 budget will be extended.
  - The government will legislate mandatory program spending limits.
  - We will establish a Debt Servicing and Reduction Fund solely dedicated to offsetting the costs of the public debt. By law, all revenues from the Goods and Services Tax and from privatization will flow into this fund.
- **We will severely restrain the operations of government**. Operating budgets will be frozen at current levels and the wages and salaries of Cabinet Ministers, Members of Parliament, all Order-in-Council appointments, and all federal public servants will be tightly restrained.

These measures reflect a fundamental commitment to strong, effective government management and control which will serve Canadians well for years to come.

They will ensure that we achieve key fiscal goals in line with the plan set out in my 1989 and 1990 budgets:

- We will eliminate new federal borrowing in financial markets after 1993-94.
- We will tightly control spending. Extending the Expenditure Control Plan will limit program spending growth to 3 per cent per year after 1991-92.
- We will hold the deficit to $30.5 billion this year and next, despite the pressures of recession. In 1992-93, with recovery and lower interest rates, the deficit will fall below $25 billion for the first time in a decade.

Chart 1
Financial requirements[1]
1990-91 to 1995-96



[1] Excluding foreign exchange transactions.

This budget will result in a better balance between fiscal and monetary policy. It will provide the lower interest rates and greater confidence essential to our economic recovery.

The economy will recover in the second half of this year and grow strongly in 1992.

Restoring economic growth is essential. But we must go beyond recovery to attain our full measure of prosperity. To do this, we must find a way to get Canadians working more effectively together, in a broad national partnership to meet Canada's competitive challenges – a partnership for prosperity.

We must begin by being honest with ourselves about the challenges we face. We must see our problems as they really are.

The fundamental problem is this: our underlying ability to compete in the world marketplace has been falling behind that of our trading partners.

We have seen how living beyond our country's means can lead only to higher inflation, higher interest rates, less investment, lower consumer spending, slower growth and fewer jobs. All this in turn contributes to a growing burden of public debt.

It is easy to point the finger at others: business and labour at government because of the exchange rate, interest rates and taxes; or business at labour because of wage levels; or labour at business because of high executive salaries and bonuses or inadequate training.

But shifting the blame will get us nowhere. The problems are caused by us all and the solutions must involve actions and co-operation by us all. There is too much at stake for anything less than a full, national effort.

The government will take the lead in a major national exercise to bring together the ideas and the efforts of Canadians, in all walks of life and from all across our country, to strengthen Canada's ability to prosper in a tough economic world.

Before describing the budget measures in more detail, I want to be very clear about why, in a time of recession, it is necessary to call on Canadians to exercise patience and restraint.

FACING UP TO ECONOMIC REALITY

Without doubt, this is the most difficult of the seven budgets I have presented. Particularly so because of the painful economic circumstances facing Canadians today.

It is clear that the weakness in our economy continued and deepened during the last quarter of 1990. I expect the economy to stabilize by mid-year after a total decline of almost 2.5 per cent in output. The unemployment rate will exceed 10 per cent in the first half of this year and then decline as growth and employment recover.

In the months leading up to this budget, I have talked with, and listened carefully to, people from all across the country. I carried out extensive pre-budget consultations with leaders of organizations representing a variety of business, labour, social and other interests. I hear directly from individual Canadians on a continuing basis, in my visits to various parts of the country, in letters and in many other ways. I have heard the anguish of people who have lost their jobs or their businesses.

While the views that we are hearing on some of the shorter-term policy issues range widely, there is little disagreement on basic issues:

- Canadians want a strong, growing economy that provides good jobs and expanding opportunities for themselves and their children. They want a government with the financial means to maintain the essential programs that help to hold this country together.

- Canadians know that the deficit and the debt are serious problems that must be solved. They know that firm, determined action is needed to solve these problems. And they believe this should be carried out with the least possible adverse impact on those in greatest need.

In designing our Plan for Economic Recovery, I have been mindful of these views. One of the best things we can do to strengthen the unity of our country is to strengthen our economic union and our fiscal position. Our approach also reflects careful sensitivity to the difficulties that many Canadians are facing today. This is evident in the fact that program expenditures will increase by 6.9 per cent in 1991-92. While this is too high in purely fiscal terms, the reason for the increase can be clearly understood in human terms.

Of a total program spending increase of $7.5 billion, here is where the bulk of the money will go: $3 billion for assistance to the unemployed; $1.6 billion for the elderly and $1.3 billion for farmers in difficulty.

We have also allocated $600 million for national defence to meet increased responsibilities in 1991-92.

These four areas will account for more than 80 per cent of the increase in program spending.

In short, the money is going where it is needed, when it is needed.

At the same time, we have acted to ensure that our medium-term goals will not be compromised, as they must not be if we are to achieve continuing economic growth.

Let there be no doubt: The actions in this budget are tough and they are challenging. And I can assure you that government and the people who work for it will feel the pinch. We will have to give better value for taxpayers' dollars.

But Canadians know that finding the solutions to Canada's economic problems will continue to demand the participation and the effort of everyone.

In this budget I am asking Canadians to share the burden of further fiscal restraint. I fully recognize the sacrifices that many Canadians have already made in the name of restraint. I know there will be some reluctance to accept the necessity for more of the same.

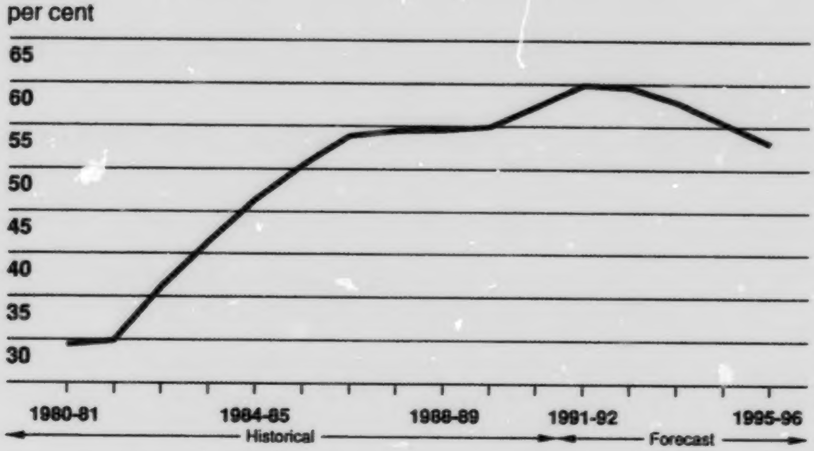
In earlier times, periods of economic weakness have been occasions for Ministers of Finance to put some extra money in people's pockets, spend more on programs, and worry less about the government's fiscal situation. But in earlier times, we did not have to face persistently high deficits, high public debt and the economic damage that would result from ignoring these serious problems. Let us not forget that during the last recession, Canada's deficit doubled from $14 billion to $28 billion. We are still struggling with the problems this caused.

Our public debt is forecast to reach $400 billion by mid-year – about $15,000 for every man, woman and child in Canada. The interest alone on the debt will eat up more than $43 billion next year – more than we spend on old age security, unemployment insurance and family allowances combined.

Since coming to office in 1984, the government has waged a long, uphill battle to reduce the deficit and bring the debt under better control. The growth of the debt has been substantially reduced. The deficit, though still too high, has been cut in half as a proportion of our national income.

Chart 2

The debt-to-GDP ratio: 1980-81 to 1995-96



Throughout this period, many Canadians have become increasingly concerned about what government can do for them, about the value they are getting for their tax dollars.

This is not surprising. In 1984, the federal government was handing out $1.33 in programs and services for every dollar it collected in taxes. That was no bargain. We are now paying the price, over and over again, for too many years of consuming more government services than we were willing to pay for – and borrowing to make up the difference.

We must get off this treadmill.

Decisions made in the 1970s and early 1980s that led to the massive debt of the 1990s have taken away many of the choices that Canadians and their governments might want to make today – choices about supporting priority programs and services or reducing taxes.

In my 1989 budget, I set out a medium-term fiscal plan to sharply reduce the deficit and bring an end to new government borrowing in financial markets by 1994-95. My 1990 budget reaffirmed this plan and introduced a program of expenditure control to meet it. However, revenues are now lower than forecast; expenditures are higher because of the weak economy; debt charges are substantially higher.

If we did nothing to deal with this worsening fiscal situation, the deficit would be significantly higher than forecast over the next five years and the public debt would increase by at least $25 billion more in the same period. This would aggravate all of the fundamental problems that must be solved if we are to ensure a strong recovery. And if we increased our spending still further, the debt problem would be just that much worse.

- Instead of lower inflation and lower interest rates, we would be sowing the seeds of higher inflation, higher interest rates and, unavoidably, higher taxes.
- Instead of making more room for productive, job-creating investment, we would be crowding out that investment.
- Instead of restoring the government's capacity to do the things Canadians want and need to build a stronger economy and a stronger country, we would be weakening that capacity.
- Instead of building greater confidence in Canada's ability to deal with its problems, we would be assaulting that confidence in a direct and irresponsible way.

While the detailed policy choices facing the government are difficult, there is no doubt about the broad course that we must continue to follow. We must stay the course we set out in 1984 and that we reinforced in 1989.

ACTION FOR RECOVERY AND PROSPERITY

The first challenge is to ensure that interest rates continue to come down. This is the key to our Plan for Economic Recovery.

We are making real progress in the battle against inflation. As a result, interest rates have declined more than four percentage points since their peak last May. But we must now build a stronger level of certainty that a further easing of monetary conditions can be achieved and sustained.

Restoring the financial stability of government is essential to build that certainty.

Extending the Expenditure Control Plan

Sustained expenditure restraint is the key to deficit reduction and debt control. Government program expenditures must carry the burden of restraint.

In the 1990 budget, the government introduced a two-year Expenditure Control Plan that affected a broad range of government spending, with some important exceptions.

The Expenditure Control Plan will be extended. Exemptions will be continued for income support programs for seniors, families and veterans, unemployment insurance, as well as the Equalization program and Canada Assistance Plan payments to lower-income provinces. Indian and Inuit programs will also be exempted.

Under the Expenditure Control Plan:

- We will extend the existing 5-per-cent cap on the growth of Canada Assistance Plan payments to the fiscally stronger provinces of Ontario, British Columbia and Alberta for three additional years.
- The existing freeze on total per capita cash and tax transfers to the provinces under Established Programs Financing will also continue through 1994-95. These transfers will continue to grow with provincial populations.
- A number of other programs will remain frozen, including payments under the *Public Utilities Income Tax Transfer Act*, payments to Telefilm Canada and concessional loan financing by the Export Development Corporation.
- Science and technology programs and cash payments under Official Development Assistance will grow by 3 per cent per year.
- The existing 15-per-cent reduction in planned funds for new social housing will continue.
- Grants and contributions to businesses, interest groups and individuals will be reduced by $75 million next year and $125 million thereafter.

In summary, programs which are exempt from the extension of the Expenditure Control Plan, accounting for 60 per cent of program spending, will grow at an average annual rate of 3.9 per cent from 1991-92 to 1995-96. All other program spending will grow at an average annual rate of 1.7 per cent.

In view of our difficult fiscal circumstances, the government has decided to reconsider a number of recent decisions.

- We will withdraw the previously announced contribution of $88 million to the Toronto Ballet Opera House, in line with the decision of the Ontario government.
- Expenditures under the Green Plan will be spread over six years instead of five.

- Funding for the Canadian Jobs Strategy will be reduced by $100 million in 1991-92.
- We will delay the provision of financial support for the construction of concert halls in Edmonton and Montreal.
- The cultural research institute in Montreal will be delayed.

Reforming government management

From the outset, we have recognized that fiscal responsibility by the government means fiscal responsibility in the government. Operating costs have been tightly restrained since 1984 and have actually declined in real terms. This was achieved by reducing the size of the public service, eliminating programs and improving efficiency.

This effort has been intensified in recent years. Since December 1989, operational restraint measures have been implemented to achieve total savings of $6 billion over a five-year period. Budgets for travel, vehicles and equipment, supplies and office space have been cut. Government construction projects in the National Capital Region have been delayed.

We recognize that Canadians expect the government to bear its share of restraint. And we recognize that politicians and federal public servants must demonstrate leadership and resolve in helping the country through this difficult period. We are therefore taking further actions to restrain costs and improve efficiency.

- The ministerial pay of the Prime Minister and Cabinet members will be frozen for one year.
- The wage budgets of departments will not be adjusted in 1991-92 for any increases in costs arising out of new collective agreements. Departments will have to absorb any such higher costs from within existing budgets. Each increase of 1 per cent in average wage settlements across the public service could lead to a loss of about 2,000 jobs.
- Over the next three years, the government is not prepared to contemplate wage increases beyond 3 per cent at an annual rate.
- Rates of salary increase for the executive category in the public service, deputy ministers and heads of Crown corporations will be limited to a level no higher than the average of negotiated settlements in the federal public service.
- The salaries of Members of Parliament and the Senate, which currently increase at the rate of inflation minus 1 per cent, will now increase at a rate which is the lesser of this formula or the average of negotiated settlements in the public service.
- We will eliminate layers of management and reduce the number of senior managers in the public service by 10 per cent.
- Capital spending and non-wage operating budgets will be frozen at 1990-91 levels.

We will continue to seek an agreement with public service unions on a work force adjustment policy that will permit the contracting-out of government services where this is shown to be cost-effective. If such an agreement cannot be negotiated, we will introduce legislation to permit contracting-out.

This program of restraint will generate savings of $3.6 billion over the next five years.

Let there be no doubt: the government and the people who work in government will be doing their part.

Details of these and related measures will be announced shortly by my colleague, the President of the Treasury Board.

Wage policy

I want to deal briefly with the approach the government is taking in its wage-setting policies. Continuing wage restraint is a key element of our Plan for Economic Recovery.

As a leading employer, the government has a responsibility to ensure that public sector wage settlements do not add to inflationary pressures in the economy. To this end, the government has exercised restraint in federal contract settlements, while maintaining the principles of collective bargaining. Wage settlements since 1987 have been lower than those concluded in the private sector and by provincial and municipal governments.

However, given the seriousness of the fiscal situation, the government believes it must exercise further restraint in concluding wage settlements with its own employees. In taking this step, the government wishes to stress that federal employees are not being singled out for restraint. All Canadians face difficulties during the present period of recession. In the past two months alone, more than 140,000 jobs were lost in the economy. In the current situation, the government must cut back in all areas of spending, including wages.

All levels of government have a responsibility to restrain their expenditures. Let us remember that we all serve the same taxpayer – the same taxpayer who must pay the price when our spending gets out of line. And we will all share the benefits of reducing government spending – the benefits of lower interest rates, stronger growth and lower taxes.

Pay restraint is particularly important at the provincial and municipal levels, including education and health services. Wages and salaries in these sectors account for 45 per cent of all expenditures. Wage settlements in these sectors have been running ahead of inflation and our ability to pay. Some provinces have already introduced programs to limit the pay increases of their employees. It is vitally important that all provinces take part.

Wage settlements in the private sector have also been contributing to inflationary pressures. Reducing these pressures will help to lower costs and improve our competitive position. This will lead to more growth, new jobs and higher incomes.

Other management and efficiency initiatives

In addition to the measures I have described, the government will proceed with a number of other actions to streamline operations and encourage efficiency as part of our Plan for Economic Recovery.

Revenue Canada will take steps to improve the collection of tax revenues owed to the government. Changes will also be introduced to permit the recovery from tax refunds of debts owing to the government.

New cost recovery measures will be developed in the areas of transportation services and border crossings.

Privatization and Crown corporations

Since 1984, the government has privatized or dissolved more than 20 Crown corporations and improved operations of those remaining. As a result, the number of Crown corporation employees has been reduced by close to 80,000 since 1984-85. In the coming year, the government will continue to divest itself of investments no longer required as instruments of public policy.

The privatization of Petro-Canada will proceed now that legislation has passed. Legislation will soon be introduced to enable the government to proceed with the sale of its shares in Telesat Canada. The government intends to privatize CN Exploration, a subsidiary of CN.

The Canada Oil and Gas Lands Administration will be disbanded and its responsibilities transferred to other departments. Petro-Canada International Assistance Corporation will be dissolved. With these actions, the last remaining institutions set up under the National Energy Program will be wound up.

The use of Special Operating Agencies will be extended to improve service and efficiency and cut costs, particularly in activities delivering services to the public and to departments. Organizations or functions to be converted to this status include the Canadian Grain Commission, Race Track Supervision, and the Intellectual Property Directorate of Consumer and Corporate Affairs. Further candidates for conversion to Special Operating Agencies will be announced in due course by the President of the Treasury Board.

The privatization program has been implemented to date through the Office of Privatization and Regulatory Affairs. Privatization remains a priority of the government. In keeping with our desire to streamline government operations, the functions of this agency will be redeployed. Ongoing and future privatizations will be managed by the Department of Finance under the responsibility of the Minister of State (Finance and Privatization).

Legislating spending limits

The expenditure restraint measures in this budget are crucial to our Plan for Economic Recovery. These measures build on a record of discipline that has reduced annual program spending growth to 3.7 per cent in the past five years compared with 13.8 per cent per year in the previous 15 years.

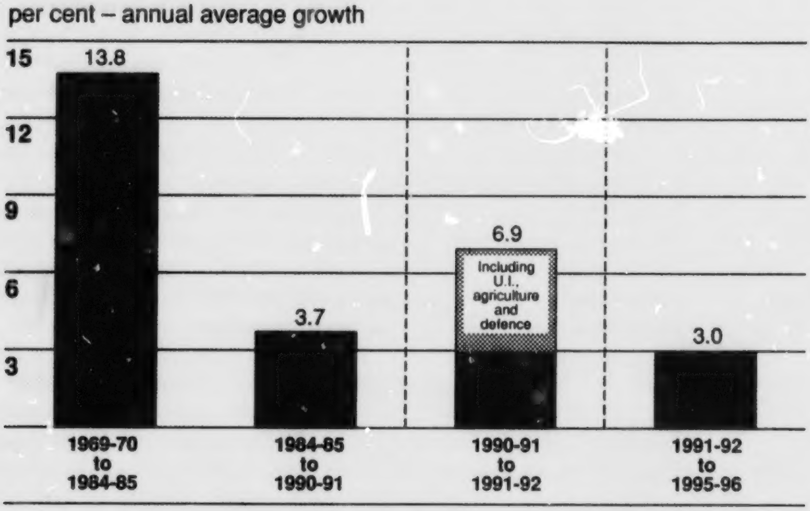


Chart 3

Growth in program spending

Having proven that we can manage spending responsibly, we can now provide Canadians with further assurance that future program spending will not get out of control again as it clearly was before 1984.

The government intends to impose mandatory, legislated limits on annual program spending for the next five years. By setting these limits in law, we will ensure that this budget's program spending track will be met. Flexibility will be provided only to meet a very limited set of contingencies that will be defined in the legislation.

This law will bring a significant change to the way government manages its expenditures. While the legislation will not preclude the introduction of new programs to meet new needs, it will mean that the government will have to fund new programs from within the total legislated spending ceiling.

The government will consult on the precise form this important legislation should take. I will release a draft bill in the next few weeks and at that time provide further details of the consultation process. Final legislation will be introduced later this year.

Allocating GST revenues to meet the debt challenge

The GST has improved the competitive position of Canadian-made goods in both Canadian and foreign markets. We have finally brought an end to the outdated manufacturers' sales tax and the damage it inflicted on growth and job creation in Canada.

I have been particularly encouraged to hear the positive response from a number of export-oriented industries already seeing the benefit of the new tax system. I am pleased, too, at the progress we have been able to make towards a harmonized system with the provinces. First Quebec and now Saskatchewan have decided to adopt the GST structure. This will pay dividends as businesses in those two provinces take advantage of the investment incentives the GST offers. The fact that provincial and federal taxes will be collected by a single administration will mean lower costs for taxpayers. Even more important, small business will be a big winner as the costs of compliance are reduced.

The competitive advantages offered by the GST are clear. At a time when Canada needs to fight hard to maintain its position in the world economy, it is all the more important for other provinces to harmonize their sales tax with the GST. It is good for the provinces. It is good for Canada.

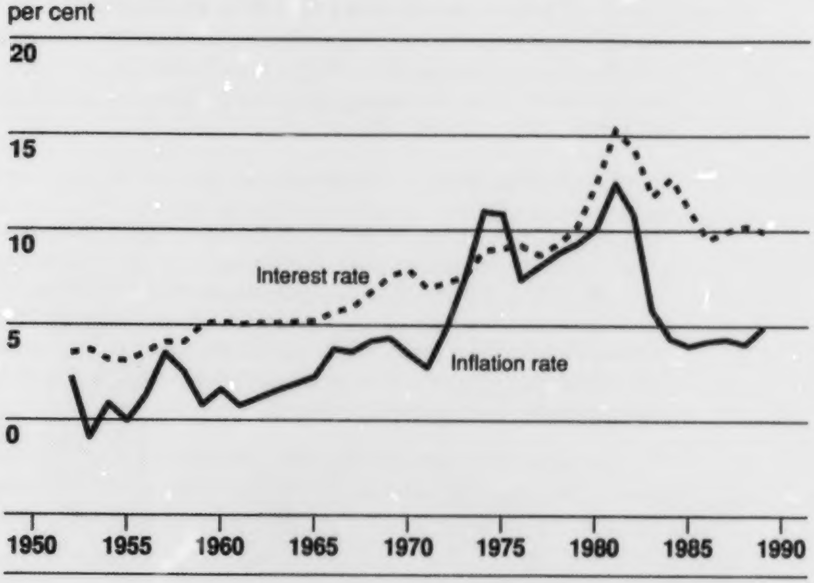
I am well aware that many Canadians have expressed concern that revenues from the GST might be used to finance new spending programs instead of helping to reduce the deficit. While the legislated spending limits I have just described should ease concerns about new spending programs, an additional safeguard will be provided.

As part of our Plan for Economic Recovery, we will ensure that all GST revenues are allocated solely to the effort to bring the public debt under control. This will be done through legislation to establish the Debt Servicing and Reduction Fund into which all GST revenues will flow. Private contributions for debt reduction and other specified revenues, such as those from privatization, will also flow into the fund. An annual audit of this fund by the Auditor General will be presented in the Public Accounts of Canada.

Establishing national inflation targets

The government and the Bank of Canada have made a clear commitment to achieving price stability in order to promote stable growth, equity and prosperity in Canada. To achieve this, our Plan for Economic Recovery includes further action to reduce inflationary pressures.

Chart 4
Canadian inflation versus Canadian long-term government bond yield



The benefits of price stability are enormous. Stable prices will strengthen our ability to compete. They will protect those least able to protect themselves, such as the working poor, the elderly and others on fixed incomes. They will result in lower interest rates by removing the inflation risk premium that lenders demand, thus making home ownership more affordable for Canadians. They will lower the cost of capital, and particularly risk capital, to Canadian businesses. Price stability will help to avoid the wasteful "boom and bust" cycle that rising inflation triggers in the economy.

As the budget papers point out, Canada's inflation for most of the postwar period has compared favourably with other industrialized countries, including Germany. From 1950-1973, our inflation rate averaged only 2.8 per cent – better than Japan's performance. There are no insurmountable barriers to attaining price stability.

Accordingly, I am announcing today, with the Governor of the Bank of Canada, that we are establishing intermediate inflation targets to serve as key steps on the way to price stability. We are committed to lowering inflation gradually to 2 per cent by 1995 and to making further progress toward price stability thereafter.

Reducing inflation requires reducing inflation expectations. The adjustment to price stability can be significantly eased by providing the public with specific targets and a clear timetable so that people know what to expect. To rely only on market pressures to bring down inflation expectations, risks an unnecessary period of economic weakness. A smoother and more rapid downward adjustment of inflation expectations will permit a substantial narrowing of interest rate differentials with the United States.

Reinforcing fiscal stability

The measures in this budget will ensure that expenditure restraint continues to make a major contribution to the restoration of fiscal stability. In my 1990 budget, there were no new taxes. In this budget, there are two specifically targeted revenue-raising measures.

Financing unemployment insurance

The unemployment insurance program is one of the most important elements of Canada's social safety net. In recognition of this, it is required by law that the Unemployment Insurance Account be maintained in a healthy condition on a self-financing basis.

Premium rates were set in 1989 for a three-year period beginning in 1990 on the basis of economic conditions expected at that time. At the current rate of contributions, the unemployment insurance fund would move from a surplus at the end of 1990 to a deficit of $6 billion by the end of 1992 because of higher than expected benefit payments.

We have seen the consequences of failing to act quickly to prevent debt problems from building up. Responsible stewardship requires that we take the necessary steps to ensure the fund remains self-financing. Accordingly, the unemployment insurance premium rate will rise by 55 cents per $100 of insurable earnings to $2.80 for employees. For employers, the rate will increase to $3.92. These measures will take effect July 1, 1991. The after-tax cost of the increase for employees with the maximum insurable earnings will be $2.70 per week.

Increased tobacco taxes

Our national strategy to reduce tobacco use addresses all aspects of the problem of tobacco consumption. In particular, it is aimed at discouraging young people from beginning to smoke. It includes initiatives in areas such as public awareness, advertising and crop substitution. This strategy has worked to reduce the use of tobacco by Canadians. Studies show that tobacco taxes are particularly important in discouraging younger Canadians from smoking.

Effective midnight tonight, the excise tax on cigarettes will be increased by three cents per cigarette. The excise tax on other tobacco products will be increased proportionately. These increases will also apply to existing inventories of tobacco products.

As a result of an expected continuing decline in tobacco use by Canadians, revenues generated by the measures are also expected to decline in the years ahead. In light of the damage to health caused by smoking, this is one kind of revenue erosion that I am pleased to accommodate. As a result of these measures, it is estimated there will be about 100,000 fewer teenage smokers.

Provincial capital and payroll taxes

Over the past decade, the provinces have made increasing use of payroll and capital taxes as revenue sources. This has raised two issues for the federal government: whether the federal government should pay provincial payroll taxes; and the impact of increasing provincial capital and payroll taxes on federal corporate tax revenues.

After a review of the issues, I am announcing our intention to continue to pay voluntarily provincial payroll taxes of general application; and to limit the deductibility of provincial payroll and capital taxes from federal corporate income tax.

This limitation will be phased in to allow sufficient time for businesses and provincial governments to adjust, and will be the subject of consultations before it is implemented. It will treat payroll and capital taxes on the same basis as income taxes. This will remove the bias in favour of those deductible business taxes which have substantially eroded federal corporate income tax revenues in recent years. Small business will be protected from the impact of the change. No additional revenue will result for the federal government, but the reliability of federal corporate income tax revenues will be protected.

Assisting disabled Canadians

Since coming to office in 1984, the government has taken major steps to promote equal opportunities for Canadians with disabilities. The Prime Minister has appointed a Minister responsible for the Status of Disabled Persons; we have passed the *Employment Equity Act*; and we have put in place fairer, more generous tax assistance.

In short, this government has done more than any other to improve opportunities and to enable Canadians with disabilities to participate more fully and more fairly in the work place, in their communities and at home.

To build on the progress that we have already made, I am today announcing further positive steps to assist disabled Canadians:

- The disability tax credit will be increased from $575 to $700 as of the 1991 taxation year.
- The definition of expenses eligible for the medical expense tax credit will be broadened and will include the cost of part-time attendants in the home.
- Costs incurred by employers in modifying their premises to accommodate disabled persons will become fully deductible in the year they are incurred.
- Benefits provided by employers to disabled persons to enable or assist them to work will no longer be taxable.

Whether in the design of tax policies or in the development of legislation and new programs for individuals with disabilities, the government has benefited from extensive consultations with groups representing the views and interests of Canadians with disabilities. The government will continue to work with these groups to improve the effectiveness of the tax system in meeting the needs of disabled Canadians.

THE PROSPERITY CHALLENGE

I want to turn now to the challenge of ensuring Canada's prosperity. It is a continuing challenge, but also an increasingly urgent one.

The key to prosperity is to increase our productivity, for this is what will determine our earning power in the years ahead. Despite strong economic growth in the past six years, the growth in our manufacturing productivity was the poorest among the Group of Seven industrial nations.

In our increasingly competitive world, there is no room for complacency; and there is no safe hiding place for uncompetitive industries or countries. We must adapt to the new world reality or fall behind in the effort to preserve and enhance our future prosperity.

This competitive challenge was central to the Agenda for Economic Renewal introduced by the government in 1984. The wide range of economic and fiscal actions taken to implement that agenda have provided a better framework for building new competitive strength.

But there are growing concerns from Canadians about our ability to compete. These concerns relate to the broad economic environment, including inflation, interest rates and the exchange rate, and to the structural problems with our productivity performance, including the effectiveness of our investments, the burden of government and the climate for business.

Governments have a responsibility to create an environment favourable to the growth of competitive enterprise. In this budget we are acting to restore fiscal balance and attain price stability. This will strengthen our ability to compete in a tough economic world.

Our ability to compete abroad begins at home. We must maintain and strengthen our economic union. In this and other areas, governments must step up the pace of structural reform. I have been working with my provincial colleagues to develop shared approaches to basic economic issues. One of the key questions to be faced is this: How much government are people willing to pay for? In our discussions, we are already looking at the rising costs of government and at overlap and duplication. In addition, the Prime Minister has asked the Economic Council of Canada to carry out a major study of the impact of governments on competitiveness.

As a further positive step, I propose to encourage greater investment in Canadian equity markets by making changes to the tax environment affecting pension plans. The aim will be to eliminate the existing bias in favour of debt investments by pension funds. This will encourage a larger source of capital for equity investments with the potential to make Canadian business more competitive. The government will discuss these proposals fully with interested parties.

But more needs to be done to assure our future prosperity. We need to look hard at the quality of our investments in infrastructure, machinery and equipment, training, education, and research and technology. There are signs that in some areas, such as private sector spending on training and research, we are not doing enough. In other areas, such as education, our level of spending compares well with international standards but our performance appears to be falling behind. In these and other areas, the co-operative efforts of Canadians in both the public and private sectors will be crucial to our competitive success.

This is not an issue only for business, labour and government. All Canadians have an enormous stake in strengthening Canada's competitive ability. The perspective of workers, consumers – people involved in every aspect of economic life – will be a valuable part of the process of identifying the problems and developing solutions.

To help assure our future prosperity, the government will launch a national effort to build a new partnership for prosperity that draws fully on the talents and efforts of Canadians in every sector of economic life. As a first step, we will release a discussion paper in the spring to help focus public debate toward the building of a broader consensus on the problems we face and the development of solutions.

FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS

This budget has important implications for federal-provincial fiscal arrangements, and particularly for the system of major transfers: Equalization, Established Programs Financing and the Canada Assistance Plan. These programs account for more than 90 per cent of the funds transferred by the federal government to the provinces to help pay for a variety of programs and services.

For decades, the federal government has provided large and growing financial support to the provinces. Next year alone, total federal transfers to the provinces will reach $36.9 billion, including both cash and tax transfers. These transfers are simply too large to exempt from our expenditure restraint program. The deficit is a national problem and it demands a national solution.

The federal government is not asking more of the provinces than it is doing itself. Major transfers to the provinces, including both cash and tax transfers, will grow on average by about 3.7 per cent per year from 1991-92 to 1995-96. All other federal program spending will grow by 3.4 per cent.

I recognize that limiting the growth of transfers under Established Programs Financing raises concerns about the ability of the federal government to continue enforcing national medicare principles under the *Canada Health Act*. Legislation will be introduced to ensure that the federal government continues to have the means to enforce these national medicare principles. The principles of the *Canada Health Act* will not be compromised.

The measures in this budget bring the growth of federal-provincial transfers into line with current fiscal realities. But it is also time to ask ourselves whether the system of transfers and tax arrangements can be reformed to better meet the emerging challenges, priorities and needs of the 1990s and beyond.

In recent months, my provincial colleagues and I have been working together to address Canada's fiscal and economic problems. I have already referred to our discussions on the question of overlapping spending. We are also working in a co-operative way on a number of important taxation and fiscal transfer issues.

Reform of the major transfer programs

The federal government will consider reforms to the major transfer programs within the fiscal framework set out in this budget. We want to ensure that, in the future, the system of transfers:

- provides for the sharing of the opportunities and benefits of Confederation;
- supports a more efficient and competitive Canada; and
- maintains the principles and standards that are the basis of Canadian citizenship while respecting provincial flexibility.

All Canadians have a stake in these reforms, and we will be considering how best to seek their views.

Discussions on the updating and renewal of the Equalization program are already well under way, and will be carried forward as an integral part of this broader process.

Federal-provincial tax collection agreements

A number of my provincial colleagues have expressed concern that federal-provincial tax collection agreements do not provide enough flexibility for them to meet their own social and economic priorities. Some have suggested that provinces should have the right under these agreements to levy provincial tax on taxable income, rather than on basic federal tax. Indeed, the possibility of establishing separate tax collection systems has been raised by some provinces.

Given the importance of these and related issues, the federal government will seek the views of individual Canadians and tax professionals. We will release a discussion paper in the spring to explore reforms to the tax collection agreements. The objective will be to assess whether the flexibility of these agreements can be enhanced while maintaining the competitive benefits of a tax collection system that is simple, and consistent, and that enhances the accountability of governments. Following these consultations, we will put forward specific proposals.

ECONOMIC OUTLOOK

Our Plan for Economic Recovery will help ensure that Canada will be a stable, attractive place for investment in new growth, jobs and opportunities for Canadians.

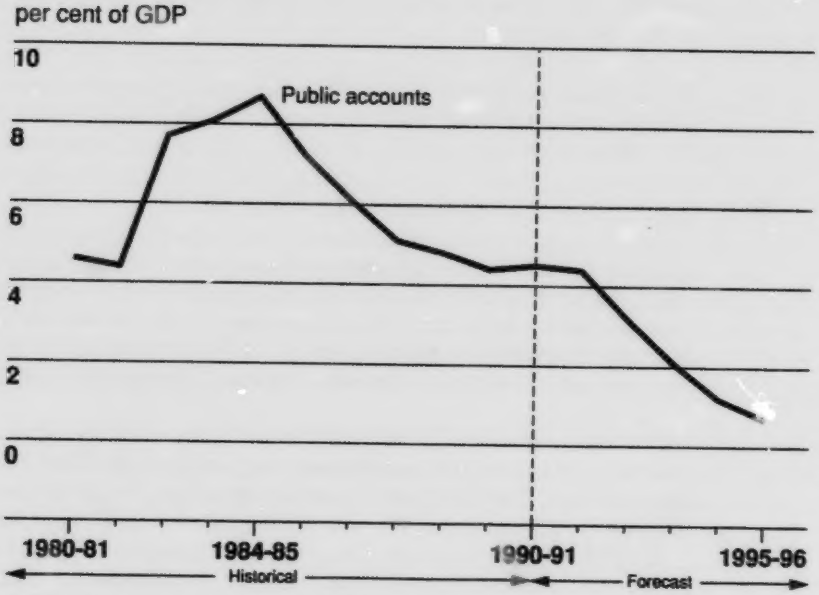
The components of our Plan for Economic Recovery reinforce each other. Lower deficits and less government borrowing will mean more favourable conditions for lower inflation and interest rates. This in turn will help to reduce the deficit by spurring stronger growth and reducing the interest costs of carrying the public debt.

The economic recovery will begin in the second half of this year and accelerate next year.

- **Inflation will decline.** The inflation rate will decline to 3 per cent by the end of next year and average just over 2 per cent in the three years thereafter. Canada's inflation rate will be significantly less than that of the United States. This will strengthen the fundamentals of our economy and our ability to compete. It will also further ease the pressure on monetary policy.

Chart 5

The deficit and financial requirements[1]
1980-81 to 1995-96



[1] Excluding foreign exchange transactions.

- **Interest rates will continue to fall.** Short-term interest rates are assumed to decline to an average of 9.5 per cent for 1991, well below the 1990 average of 13 per cent. This will contribute to a rebound in consumer spending and housing starts.
- **Strong economic growth will be secured.** Real output will expand by 3.5 per cent in 1992 and average 4 per cent in the medium term. Real personal disposable income will grow steadily throughout the period. Employment growth will begin in the second half of this year and will strengthen in the years ahead.

I am tabling the budget document including Notices of Ways and Means Motions. Details of the measures are included in the document.

I will also introduce a bill seeking borrowing authority for the 1991-92 fiscal year.

I am asking that an order of the day be designated for consideration of those motions.

CONCLUSION

Mr. Speaker, this is a strong budget – a budget for economic recovery.

It deals resolutely with our fiscal challenges.

It imposes strong disciplines on government spending.

It requires vigourous restraint in government operations.

It sets out a clear path toward lower inflation and lower interest rates.

It is designed to give Canadians confidence that we are facing directly our immediate economic and fiscal problems.

But it does more than that. It establishes a clear direction as to how we must face the more fundamental problems undermining the competitive position of our economy, and it is sensitive to those in greatest need.

In short, it will provide leadership and direction in our economic affairs at a time when Canadians are asking fundamental questions about the future of our country.

Our Plan for Economic Recovery is different from those in previous recessions.

Our plan does not have the government throwing large amounts of money at problems. Those are band-aid solutions.

This government is dealing in a fundamental way with the problems that it can directly influence. This is the best way to generate a positive environment in which Canadians can live and work.

It asks Canadians to do the same in the more positive environment which the plan will foster.

But I would add something else, Mr. Speaker. Too often Canadians complain that some other region of the country or some other group is doing better than they are. The challenge to all Canadians is to do what each of us can do to strengthen our country.

At this time of great stress in our national unity, it is important to put aside jealousies and defeatism and start working together for our country.

Canada has come a long way in 123 years. Let's not sell ourselves short. Let's start thinking positively and take heart from our past success.

We have forged a country that is the envy of the world – a tolerant and open society with the world's second highest standard of living.

This prosperity was put at risk by abandoning the traditional Canadian value of paying our way.

I believe that this budget will help us regain some of the key elements that brought us strong growth in the past – low inflation, responsible financial management and a desire to work together to succeed.

The realization of this can rekindle our pride and give us a solid basis for hope and confidence in the future – hope that is important at this time in our history. For a strong economy will strengthen our national unity – and faith in our national unity will reinforce our economic strength.

We all wish to see a strong, united and prosperous Canada. Our Plan for Economic Recovery will help us achieve that goal.

CHAPTER 2: CANADA'S ECONOMIC PERFORMANCE AND PROSPECTS

RECENT ECONOMIC PERFORMANCE

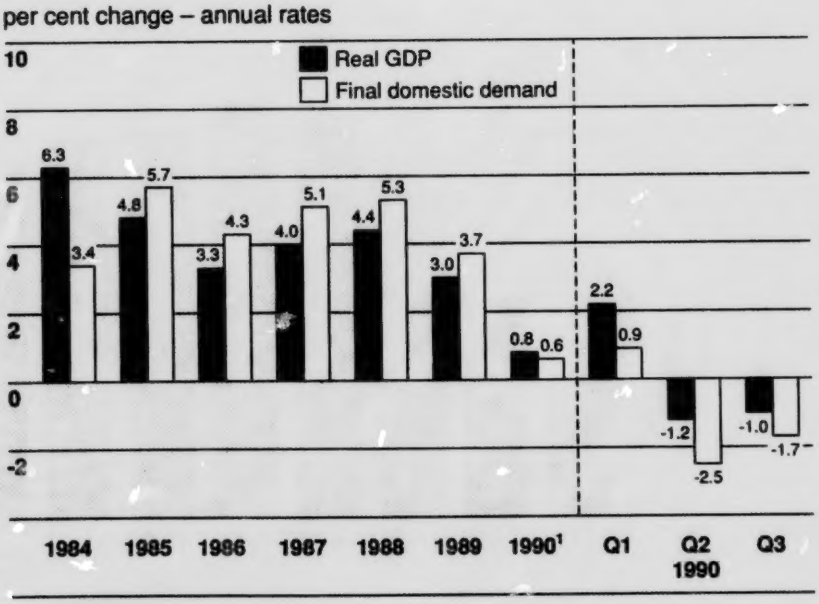
Canada in a recession

The Canadian economy expanded faster on average than other major industrial economies with the exception of Japan from 1983 to 1989. By early 1988, however, this robust expansion was starting to strain the economy's capacity to meet the rapidly rising demands for goods, services and trained workers. Further strong growth through 1988 and into 1989 pushed domestic demand beyond the economy's capacity to produce; excess demand was apparent in both product and labour markets and in the growth of debt, creating strong inflation pressures. Their persistence, combined with firmly anti-inflation monetary policy, resulted in tighter monetary conditions as interest rates rose and the dollar appreciated.

Although inflation pressures remained intense, and monetary and fiscal policy tightened in response in 1988 and 1989, overall economic growth did not begin to slow until late 1989. Economic activity declined in the second quarter of 1990,

Chart 1

Growth in real GDP and final domestic demand



¹ Estimates.

causing the first quarterly decline in GDP since 1986; a further decline in the third quarter confirmed that the economy was in a recession (Chart 1). All available indicators show that the contraction intensified in the fourth quarter of 1990.

The economic downturn has been largely concentrated in interest-sensitive categories of final domestic demand and in industries most exposed to international competition. The downturn has been marked by consumer retrenchment, cuts in business investment, and tight inventory control.

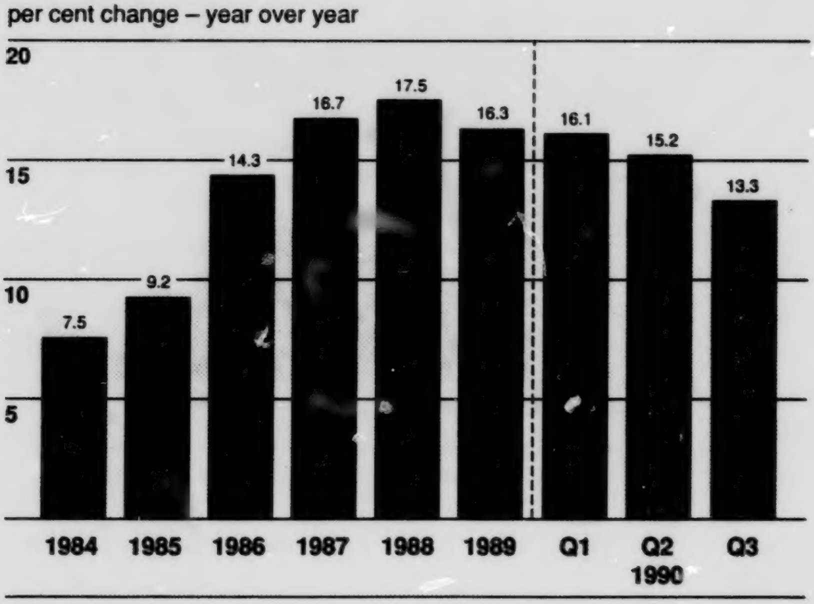
Consumers retrench

Throughout the expansion from 1983 to early 1990, household spending increased strongly, particularly on big-ticket items. These expenditures were fuelled by strong consumer credit growth, particularly in recent years. Household credit grew at double-digit rates during most of the expansion (Chart 2), pushing personal debt burdens to a near-historical high by early 1990.

Housing starts reached a high of nearly 270,000 units (annual rate) in mid-1987, and remained above 200,000 through the first quarter of 1990. Since then, they have fallen sharply, dropping to 144,000 units by the end of 1990.

The related demand for consumer goods such as appliances and furniture increased then declined correspondingly. Auto sales, which account for nearly one-half of

Chart 2
Growth in household credit demand



consumer-durables spending, peaked in late 1988 and have been weakening since then. Altogether, consumer spending on durable and semi-durable goods has fallen steadily since the first quarter of 1990.

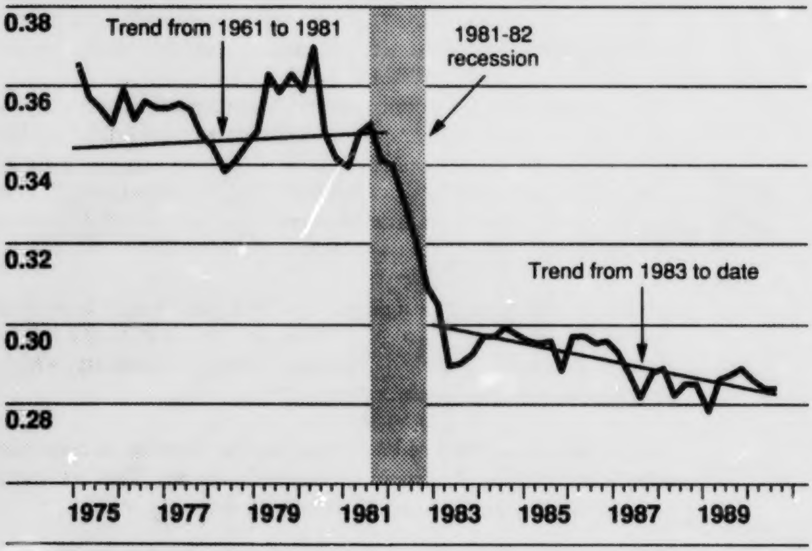
Businesses cut investment

From 1985 to 1989, business investment was the engine of growth in the Canadian economy. As a share of real GDP, non-residential business investment reached a peak of 13.6 per cent in 1989, up from 11 per cent in 1984. Strong demand, healthy balance sheets, and the government's structural reforms – such as Tax Reform and the Canada-United States Free Trade Agreement – increased the incentive to invest.

Corporate profits have declined steadily since the first quarter of 1989, registering a cumulative drop of more than 25 per cent. Squeezed profit margins and declining sales prospects have caused businesses to reduce their investment spending. Business non-residential investment peaked in the second quarter of 1989, and has declined in four of the last five quarters. The decline has been in machinery and equipment spending, while non-residential construction investment has continued to grow, although weakly.

Despite the sharp drop, investment remains high by historical standards – a measure of the vibrancy and confidence of the business sector during the 1985 to 1989 period. As a share of real GDP, real business non-residential investment was still over 12 per cent by the end of 1990, in line with the average share of the 1980s, but well above that of the previous three decades.

Chart 3
Business non-farm inventory-to-sales ratio



Inventories tightly controlled

A large inventory liquidation is not expected in the present downturn, because businesses have maintained tight inventory control since the 1981-82 recession. In 1981-82, owing to high financing costs and plunging demand (Chart 3), businesses massively cut their inventories in relation to sales. The inventory rundown associated with this structural adjustment accounted for about four-fifths of the total decline in GDP during the recession. Since 1983, firms have shifted to just-in-time delivery practices or other controls to respond more quickly to changes in demand, reducing the economy's vulnerability to large swings in demand.

Trade balance improves

Changes in the Canadian trade balance tend to be countercyclical. A large surplus had emerged by 1984 in response to previously weak domestic demand and a rapidly growing export market in the United States. This balance deteriorated throughout the expansion, as strong growth in consumer and investment expenditures relative to the economy's capacity to produce led to corresponding increases in imports, outpacing the growth of exports. By the first quarter of 1990, a record current account deficit of $20.8 billion was one result of an overheated economy with deteriorating competitiveness.

The current weakness in the domestic economy is producing an improvement in the trade balance. Nominal exports expanded in 1990, while import growth slowed sharply due to the declines in consumer and business spending. The resulting improvement in the merchandise trade balance is reflected in the current account deficit, which was down from its first-quarter high to $13.7 billion in the third quarter of 1990.

Goods-producing industries bear the brunt

Goods-producing industries have borne the brunt of the recession, owing to both the decline in interest-sensitive domestic demand and the slowdown in export growth.

These losses have been concentrated in construction and manufacturing. Manufacturing was the first major industry to weaken. It has declined since mid-1989 as foreign and domestic demand weakened and domestic unit labour costs rose much more rapidly than those of foreign competitors. The contraction in manufacturing has been broadly based, although declines in the second half of 1990 were worsened by strikes in a number of industries.

Job losses in manufacturing have also been particularly large. Employment has fallen faster than output as firms have attempted to keep a rein on rapidly growing unit labour costs. As a result, manufacturing productivity, which sharply declined in past recessions, has continued to grow.

During the second half of 1990, an abrupt weakening in construction contributed significantly to the decline in goods-sector output. This was particularly evident in residential construction, which fell more than 25 per cent.

In contrast, output in services industries has declined only slightly in the current recession, after strong growth in the preceding six years. Service-sector weakness was concentrated in the fourth quarter, and was led by weakness in wholesale and retail trade. These declines largely reflected cuts in both consumer and business-capital spending.

Recession most evident in Central Canada

After outpacing most industrial countries from 1983 to 1989, employment in Canada has declined 2.0 per cent since March. Central Canada has accounted for most of the decline since the onset of the recession (Chart 4). Indeed, Manitoba is the only other province that has experienced a decline in employment in the recession, but one which has been less severe than in Central Canada. The recession has been felt particularly strongly in Central Canada because of the high share of manufacturing in its industrial structure. Moreover, even within the manufacturing sector, employment losses have been disproportionately concentrated in this region.

While current employment prospects have worsened, the labour force has continued to expand in most regions, albeit slowly. The unemployment rate has risen in all regions since early 1990, but particularly in Central Canada. From an eight-year low of 7.2 per cent in March, the Canadian unemployment rate rose to 9.7 per cent in January 1991. In Ontario, the rate has increased more sharply, from 5.3 per cent to 8.4 per cent – a 3.1 percentage-point increase.

Chart 4
Employment by province
Cumulative change, March 1990 to January 1991

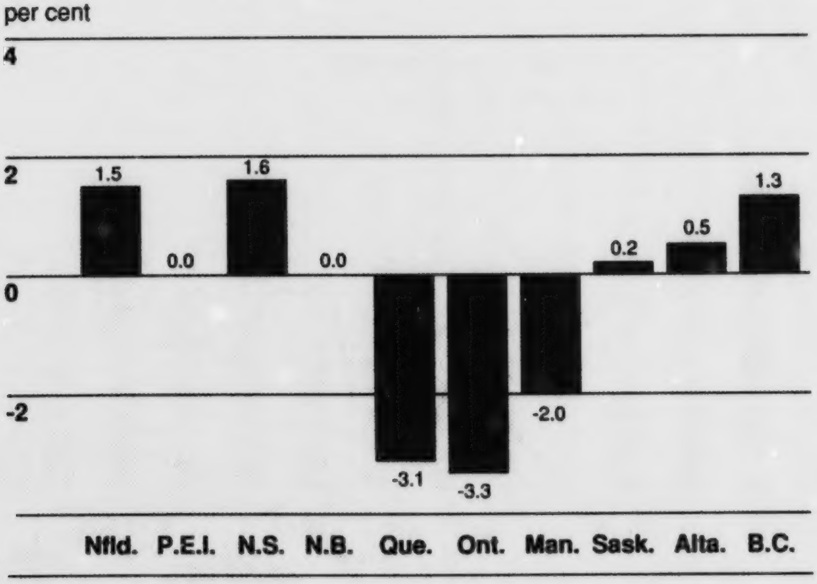


Chart 5a
CPI inflation rate

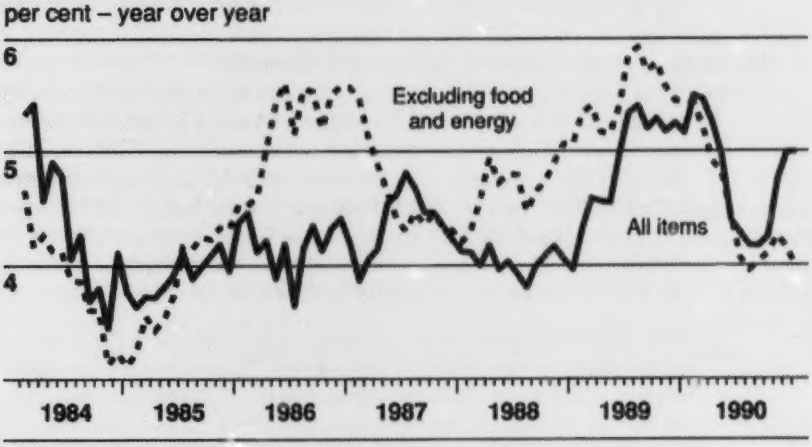
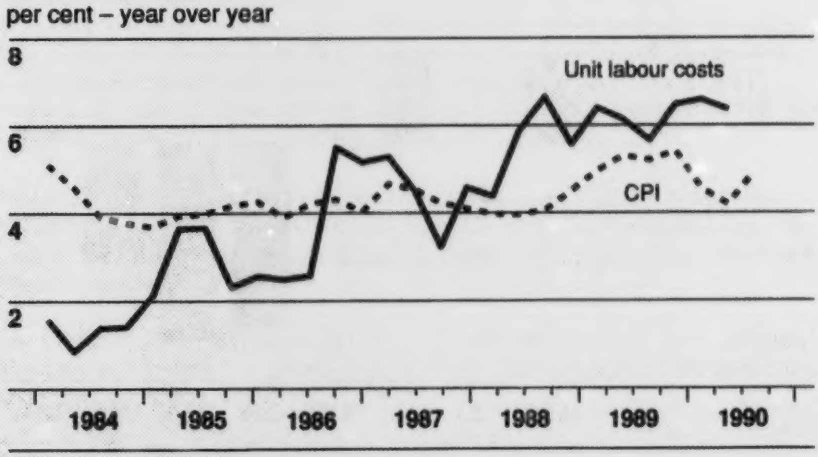


Chart 5b
CPI inflation and growth in unit labour costs



The retrenchment in consumer spending and residential and business investment has been evident across Canada, but most severe in Ontario and Quebec, reflecting the pattern of employment losses. These losses compounded household financial imbalances emerging from the particularly strong debt accumulation in 1988 and 1989. Housing construction fell very sharply in Ontario during 1990, with starts dropping to about one-half their 1989 level by the end of 1990. January data show a slight firming of housing starts in Ontario but a steep decline in Quebec and Atlantic Canada.

Underlying cost pressures a concern

After remaining virtually stable near 4 per cent for five years, inflation measured by the consumer price index rose sharply to 5 per cent in 1989 (with increases widespread across major components and regions) and only fell to 4.8 per cent in 1990 (Chart 5a). The rise in inflation would have been much more pronounced if it had not been for the appreciation of the Canadian dollar and a steady erosion of corporate profit margins, which reflected businesses' inability to pass through accelerating unit labour costs in weak market conditions (Chart 5b).

Another indication of the strength of underlying cost pressures is obtained from wage rates. Growth in average hourly earnings (adjusted to account for changes in industrial composition) increased from about 4½ per cent in late 1988 to over

Chart 6
Private and public sector wage settlements

effective annual per cent increases

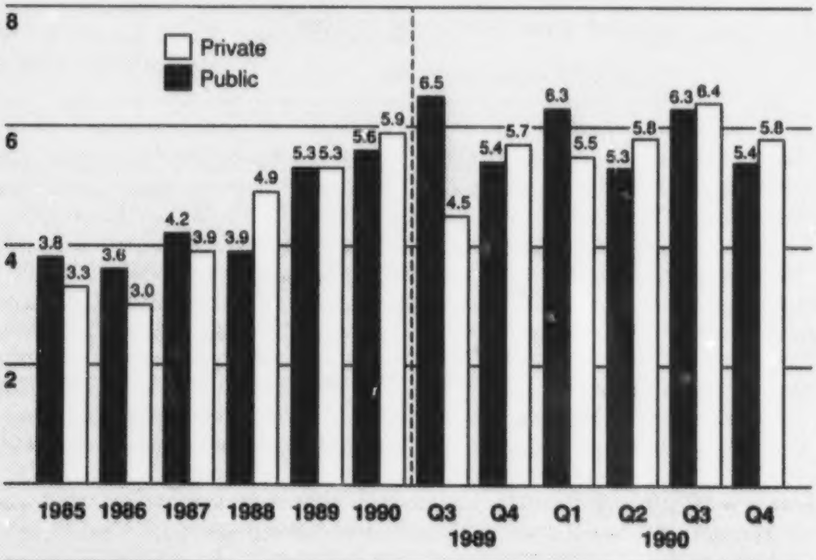
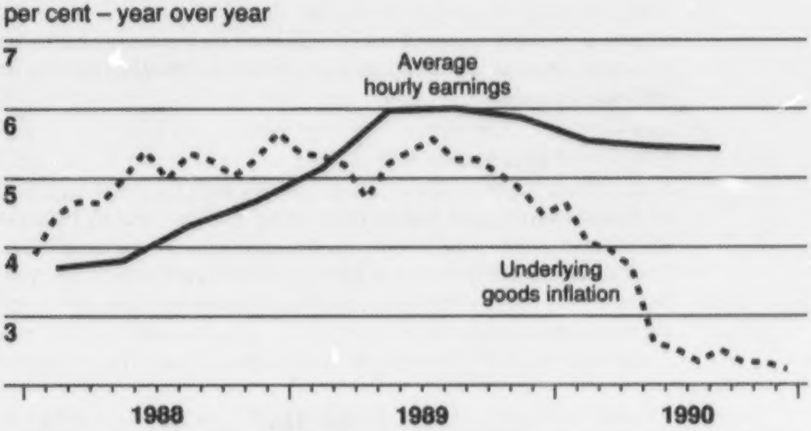


Chart 7a

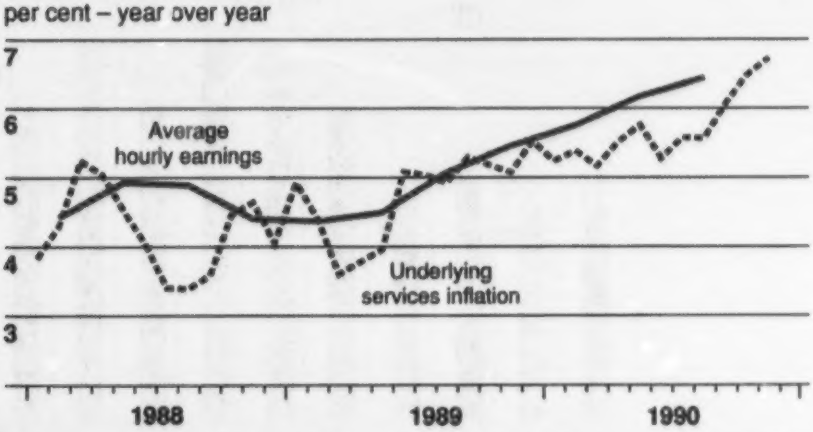
Canadian goods sector[1]



[1] Goods sector CPI inflation excludes food and energy. Earnings series are fixed-weighted.

Chart 7b

Canadian services sector[1]



[1] Services sector CPI inflation excludes shelter. Earnings series are fixed-weighted.

6 per cent by mid-1990, and has remained high. The average quarterly wage settlement in both the private and public sectors fluctuated between 5¼ and 6½ per cent in 1990 (Chart 6). Since labour costs account for more than half of business operating expenses, inflation cannot be steadily reduced without a sustained reduction in wage growth. Equally important, improvement of Canada's international competitive position requires an easing in underlying cost growth.

The risk to competitiveness from continued strong wage growth is most evident in the goods sector (Chart 7a). While wages increased rapidly in this sector – faster than justified by productivity gains – in 1989 and 1990, international competition has forced companies to keep price increases low, causing a precipitous and unsustainable decline in profit margins. This profit squeeze is leading to a cutback in investment spending and a deterioration in corporate balance sheets. In the services sector, prices have increased in line with persistent increases in wage costs, as the sector has been less vulnerable to demand weakness and import competition (Chart 7b).

CAUSES OF THE RECESSION

The fundamental cause of the current recession was the rapid build-up of inflation pressures from 1988 to 1990 and associated entrenchment of inflation expectations. As shown in Chart 5a, the rate of inflation accelerated from 4 per cent in 1988 to near 5½ per cent by the summer of 1989. Both the April 1989 and February 1990 budgets acknowledged the threat to economic growth posed by these continued pressures. Consequently, these budgets contained strong fiscal measures aimed at not only reducing the deficit but also directly reducing demand pressures. At the same time, monetary policy was clearly aimed at resisting both strong credit growth and increasing inflationary pressures in the economy. Together, the fiscal and monetary measures were intended to create an environment conducive to lower interest rates, less dependence on foreign savings, and sustainable non inflationary growth.

Stronger-than-expected inflation brings tighter monetary conditions

The transition of the economy to non-inflationary growth was expected to slow growth and increase unemployment. The 1990 budget emphasized that growth would be weak in 1990, with the possibility of a decline in output. It also stressed that the transition would be shorter and smoother the more quickly inflation pressures fell and expectations changed. Demand continued growing faster than expected in the first quarter of 1990, however, supported by continued strong credit growth. Consequently, underlying cost pressures became even stronger, rather than abating, and inflation expectations became more firmly entrenched. This forced monetary conditions to remain tighter than forecast in last year's budget. Tighter monetary conditions, a faltering U.S. economy, and declines in business and consumer confidence turned the projected slowdown into a recession.

The tightening in monetary conditions throughout 1989 and early 1990 was evident in both higher interest rates and a stronger exchange rate. Short-term interest rates have been higher than long-term rates since late 1988 – indicating a firm

Chart 8a
Short and long-term interest rates

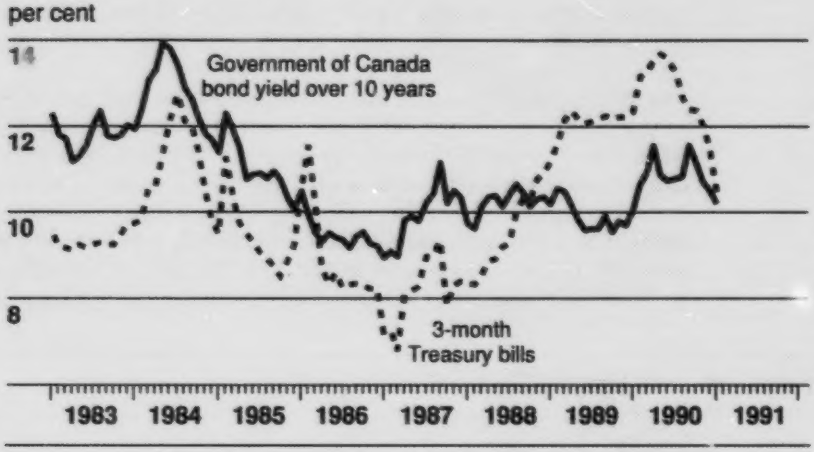
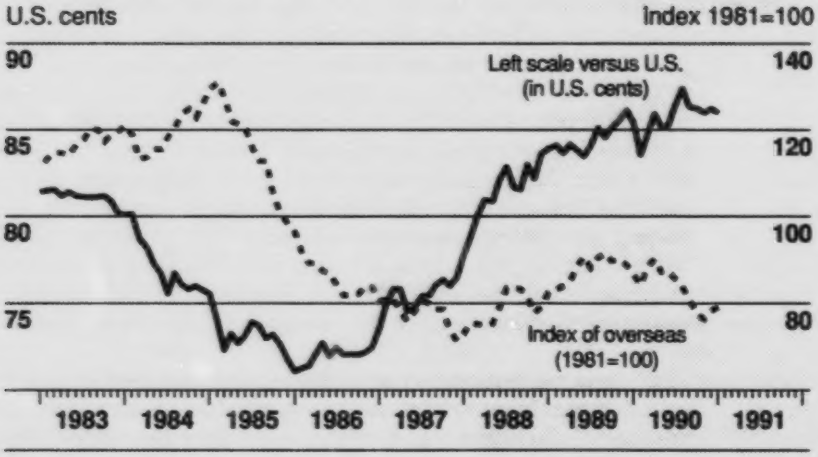


Chart 8b
Canadian exchange rates



anti-inflation monetary stance. Both short-term and long-term rates increased from late 1989 through mid-1990 before easing during the second half of the year (Chart 8a). As the differential between Canadian and U.S. short-term interest rates increased through the first half of 1990, the Canadian dollar appreciated against the U.S. dollar. The Canadian dollar began to depreciate relative to other G-9 currencies as the U.S. dollar itself slipped against these currencies (Chart 8b).

Weakening balance sheets, declining confidence curb spending

Cuts in business and personal spending in 1990 were related to weakened financial health and declining confidence. Strong personal debt accumulation between 1986 and mid-1990, combined with high interest rates, pushed the cost of debt servicing steadily higher (Chart 9a). This, along with concerns about job prospects, hurt confidence, making consumers less willing to make large purchases. Consequently, credit growth has slowed significantly since mid-1990.

In the business sector, the combination of declining profits and accumulating debt pushed the debt servicing burden to a near record high (Charts 9b and 9c), undermining business confidence and discouraging non-residential capital spending.

External factors deepen and prolong downturn

Unlike the onset of most previous recessions in Canada, the onset of the present one was not accompanied by a U.S. recession. However, after a year and a half of slow growth, the U.S. is now in a recession. Most analysts predict that it will be neither long nor severe, but it will deepen and prolong the recession in Canada. The impact of the U.S. recession will be moderated by the performance of overseas markets, which have remained strong.

Chart 9a

Interest costs on household debt as a share of personal disposable income

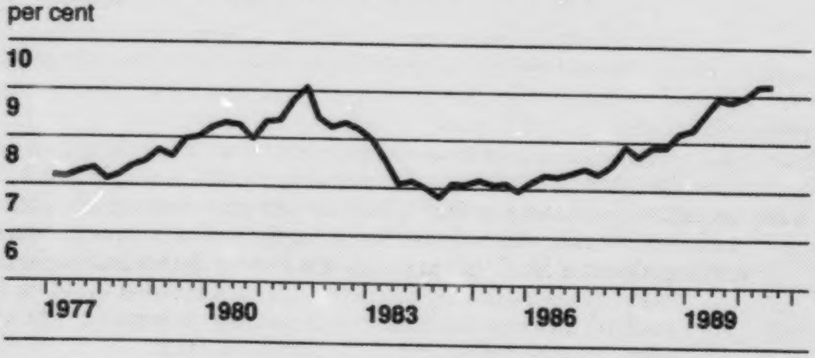


Chart 9b
Profit margins
industrial corporations

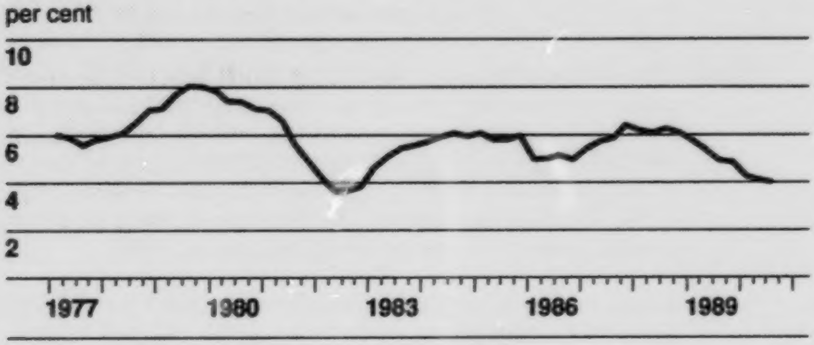
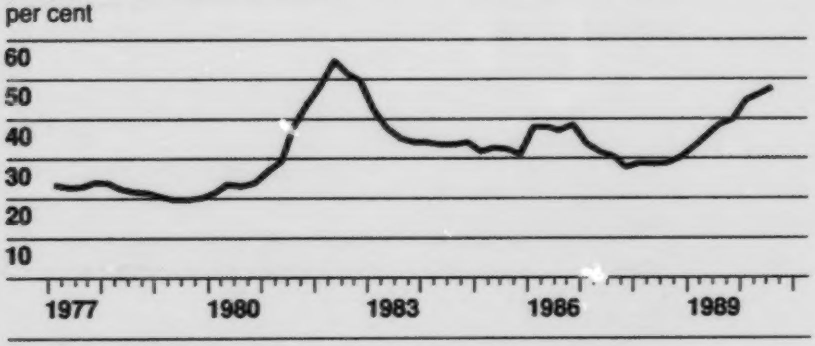


Chart 9c
Debt servicing burden[1]
large industrial corporations



[1] Ratio of interest costs to before-tax earnings plus interest costs.

Iraq's invasion of Kuwait in August last year sent crude oil prices soaring from less than U.S. $20 a barrel in July to an average of over U.S. $31 in the last five months of the year. Higher fuel costs for consumers and businesses and a further erosion of confidence have prolonged the weakness in domestic demand. The outbreak of hostilities in the Gulf in January did not lead to the feared strong rise in world oil prices; indeed, oil prices declined somewhat. Until the Gulf crisis is resolved, however, uncertainty will continue to negatively affect household and corporate confidence, both in Canada and the U.S.

KEYS TO RECOVERY

The key to a sustained economic recovery is a permanent decline in both inflation and inflation expectations that will allow a substantial and durable reduction in interest rates. The government's plan for economic recovery is aimed at achieving this by reducing inflation expectations in three important ways: first, by ensuring continued spending control that will lead to a balanced budget in the mid-1990s; second, by the adoption of a responsible anti-inflation wage policy for the federal public service; and third, by setting out clearly the inflation targets of the government over the next five years so that expectations can adjust in advance.

A sustained recovery needs:

Lower inflation pressures

Lower inflation is the key to significantly lower interest rates over the medium term. In an inflationary environment, investors demand a premium on interest rates as compensation for both expected losses in purchasing power and uncertainty about the future path of inflation. The higher the inflation rate and the greater the inflation uncertainty, the higher the premium – in short, the higher will be interest rates.

Progress is being made in reducing underlying inflation pressures. This has underpinned the sharp declines in interest rates since the spring of 1990. Clearly the recent declines in interest rates must be maintained and further easing in monetary conditions is necessary. One of the reasons for announcing explicit inflation targets leading over time to price stability is to encourage a rapid lowering of inflation expectations so that the interest rate reductions can be substantial and durable.

Continued progress towards fiscal stability

The greatest single contribution the government can make to reduce inflation expectations is to balance the budget and begin to pay down the public debt. As part of a medium-term plan to restore fiscal balance, the government has consistently acted to control growth of program expenditures, restructure the balance between program spending and revenues, reduce the deficit, and eliminate financial requirements. With a debt-to-GDP ratio of 57.3 per cent in 1990-91 compared with 29.4 per cent a decade earlier, further substantial progress is an economic and fiscal necessity.

Deficit reduction has several direct and durable economic benefits, even in the near term. It lessens the government's claim on savings and Canada's reliance on foreign debt. This reduces pressure on real interest rates and the real exchange rate, creating conditions conducive to a recovery of investment and a strengthening of net exports. It increases market confidence that we will make continued progress against inflation. This, in turn, can lead to a further easing of monetary conditions. Fiscal restraint can lead to lower interest rates that will reduce the severity of the downturn and increase the strength and durability of the coming expansion.

One lesson stands out from the 1960s and 1970s: deficit-financed economic recoveries are not sustainable, and are often not effective even in the short term. The economic evidence shows that we cannot spend our way to economic health. The severe economic and fiscal dislocation of the 1981-82 recession, which occurred because inflation had been allowed to rise to double-digit levels, underlines the costs of allowing inflation psychology to become ingrained and of being slow to resist inflation pressures. Hard decisions to reduce the deficit taken in recent years are also testimony to the ongoing costs of failure to deal in a timely and adequate way with the fiscal problems that built up in the late 1970s and early 1980s.

Sustained recovery also requires:

Restored household and corporate financial health

In virtually every postwar recession, household spending on big-ticket and interest sensitive items such as durables and housing has led the economic recovery. Investment, which typically takes longer to revive, is usually the engine that sustains recovery rather than starts it. Lower interest rates will directly stimulate interest-sensitive spending, but a lasting recovery also requires rebuilding of financial positions. The present period of retrenchment, while difficult, will allow balance sheets, both household and corporate, to be rebuilt to launch a period of durable growth.

Increased household and business confidence

Lower interest rates and a rebuilding of balance sheets are preconditions for increased household and business confidence. Further, confidence is based on longer-term expectations of a stable economic and social environment, including improved employment opportunities, as well as sales and investment opportunities, both at home and abroad.

This is why there can be no short-cut to a sustained economic recovery. Confidence must be earned. It requires perseverance in deficit reduction, inflation control, and efforts to increase competitiveness.

Enhanced international competitiveness

Export growth, alongside a resurgence in consumer spending, has been one of the traditional keys to Canadian recoveries. The present U.S. recession is expected to be moderate, which means that the U.S. recovery will contribute to a recovery in Canadian exports as has been the case in other recessions.

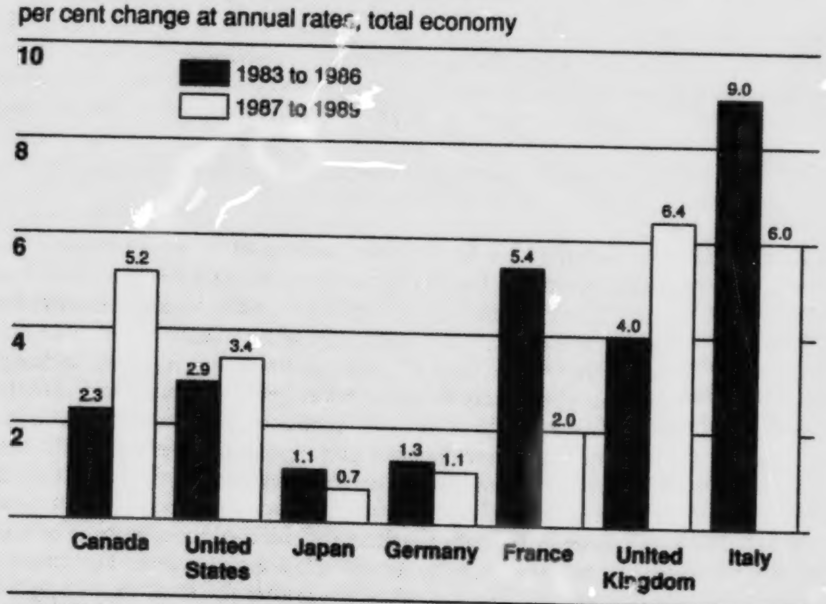
With over 50 per cent of our GDP exposed to trade, increased competitiveness is vital for a sustained recovery and a higher standard of living. Wage costs have escalated and productivity growth has slowed in Canada in recent years, however, leaving this country with one of the faster rates of growth in unit labour costs among the G-7 countries (Chart 10). From 1987 to 1989, for example, Canadian unit labour costs grew at over seven times the Japanese rate, almost five times the German rate, and 50 per cent above the U.S. rate.

The loss of manufacturing competitiveness with the U.S. has been due more to faster growth in unit labour costs than to the appreciation of the Canadian dollar (Chart 11). Canada's unit labour costs have increased substantially in both Canadian and U.S. dollars: the deterioration is not just due to the appreciation of the Canadian dollar. Reduced competitiveness with the U.S., our largest trading partner, has serious consequences for longer-term performance.

The government has put in place a number of structural reforms that will help raise Canadian productivity and allow Canadians greater and fairer access to world markets. Sales and income tax reform, reform of the unemployment insurance system, regulatory reform, privatization, and the Canada-United States Free Trade Agreement are expected to improve substantially Canada's productivity and ability to compete in international markets. In fact, the Free Trade Agreement and the replacement of the Federal Sales Tax with the Goods and Services Tax on their own will raise Canada's productive capacity by close to 5 per cent over the next five to eight years.

To realize the benefits of these structural reforms and improve Canada's competitive position in the changing world of the 1990s, we must create a stable macroeconomic environment. Price stability and sound financial management by all levels of government are crucial; without them, we risk losing the full potential

Chart 10
Growth of unit labour costs measured in domestic currencies

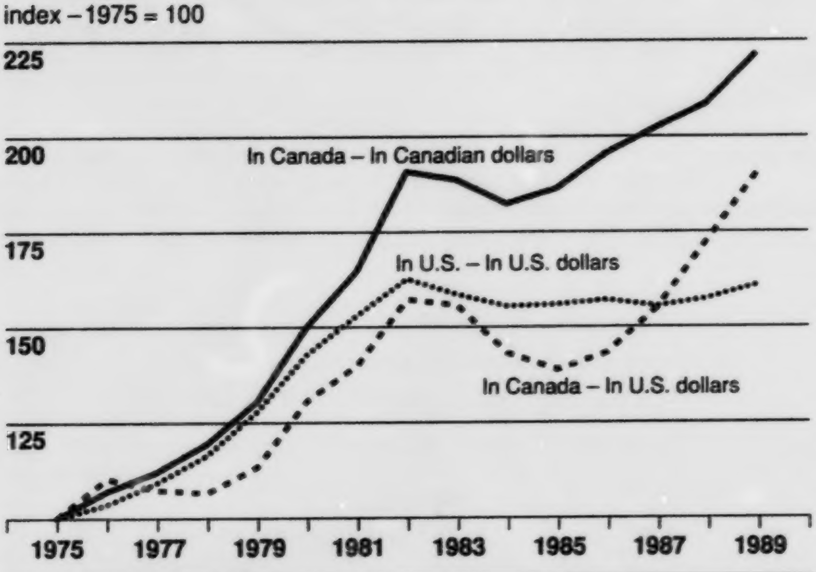


Source: OECD, *Economic Outlook*, June 1990.

benefits of the structural reforms. But they are not enough. Improved economic health involves all stakeholders and requires a strong and dynamic industrial structure. Rising productivity growth and a more flexible Canadian marketplace are essential to higher Canadian living standards in the 1990s. These issues are discussed more fully in Chapter 7.

Chart 11

Unit labour costs in manufacturing in Canada and the United States



Source: United States Bureau of Labor Statistics.

Conditions favourable to further easing of interest rates

Inflation pressures have been easing as excess demand for goods and services has been reduced. Underlying inflation (excluding food and energy) was almost 2 percentage points lower at the end of 1990 than in mid 1989. Short-term interest rates are now more than 375 basis points lower than their spring peak in 1990. Conditions necessary for an additional easing in monetary conditions now exist: there is slack in labour markets, particularly in Central Canada; and capacity utilization rates have declined from unsustainably high levels, opening the possibility of further reductions in underlying cost pressures. To date, however, labour costs have shown few signs of easing. These pressures have been offset by a squeezing of profit margins. Indeed, the recent spate of business closures and layoffs show that the situation is not sustainable. The longer a balanced decline in cost pressures takes, the greater the pressure on corporate cash flow and business investment.

A durable reduction in interest rates depends on lower inflation and permanently diminished inflation expectations. Otherwise, cost pressures will again emerge as the economy strengthens in the coming expansion. We would then risk repeating the cycle of rising inflation, higher interest rates, and economic weakness.

The government's commitment to a measured and explicit path to price stability will play a key role in reducing inflation expectations (see Chapter 5). Its medium-term fiscal objectives, which will eliminate new government borrowing in financial markets by 1994-95, will also help assure Canadians that inflation will continue to be reduced.

SHORT-TERM ECONOMIC PROSPECTS, 1991 AND 1992

Further declines in output are expected during the first half of 1991. Overall, the recession is expected to result in a peak-to-trough decline in real output of just under 2½ per cent over its five-quarter duration. In the third quarter of 1991, however, the economic fundamentals for recovery are expected to be in place, led by significant reductions in interest rates. The expected recovery in the United States will increase demand for our exports. These two factors, combined with lower oil prices than in the second half of 1990 and continued growth in overseas economies, will strengthen economic activity in the second half of 1991 and through 1992.

Most private-sector forecasters share this view. In the Department of Finance's most recent forecast survey, conducted in late January 1991, the consensus (an average of forecasters surveyed) projected a recession of similar duration and a reasonably strong recovery in the second half of the year.

The short-term outlook for the economy is detailed below. Owing to the importance of international influences in shaping the outlook for Canada, a brief overview of the outlook for world oil prices and the prospects for the United States and overseas economies is provided first.

The external economic environment

World oil prices

The oil market has been volatile since the Iraqi invasion of Kuwait in August 1990. During the past six months the international price of oil has soared as high as U.S. $40 a barrel and plunged below U.S. $20. Clearly, uncertainty surrounds any forecast of the price of oil. Current market conditions indicate that the equilibrium price of crude oil is about U.S. $20 to $25. It seems reasonable to assume that, after a transition period from the hostilities in the Gulf, the price will settle in this range. Owing to present uncertainties, however, the path to that price may be volatile.

For the economic and fiscal forecasts underlying this budget, we assume the price of West Texas Intermediate at Chicago will average U.S. $24 a barrel in 1991. This is somewhat above the trading price of early February; we have considered it prudent to allow a buffer for further price pressure. Assuming no disruption in oil supplies, the price is expected to fall to an average of U.S. $22.25 in 1992. Over the medium term, the real price of oil is expected to increase, on average, about 1 per cent a year.

If actual prices are much higher or lower than assumed, output and inflation prospects will change. For example, our analysis indicates that, as a rule of thumb, a $5-per-barrel increase in the price of oil above our projection, maintained for one year, would reduce real output by about 0.3 per cent and increase the level of the CPI by about 0.6 per cent. The decline in output reflects a reduction in domestic demand due to a decline in real personal disposable income and a reduction in the profits of non-energy corporations. In addition, the level of exports would fall due to weaker activity in the economies of our major trading partners.

If an increase in the price of oil is perceived to be permanent, then the impact on the outlook will be more favourable than the "rule-of-thumb" cited above, since energy-related investment in Canada will rise. Further, a sustained increase in oil prices would be more likely to feed into other energy-related prices. Since Canada is a large net energy exporter, this will improve the terms of trade and boost real incomes. Overall, for perceived permanent increases in oil prices, there would be virtually no change in Canadian real output – increased domestic activity would be offset by the effects of lower economic activity in our major oil-importing trading partners. These results are symmetric for a fall in oil prices.

Prospects for the United States and overseas economies

The U.S. economy contracted in the fourth quarter of 1990, due to a broad-based decline in private final domestic demand. The downturn followed a year-and-a-half of near stagnation with output growth at an annual rate of only 1.2 per cent. This period of slow growth largely reflected a progressive tightening by the Federal Reserve Board from March 1988 to the spring of 1989 and credit rationing by banks due to increasing strains in the financial system. In an already weak economy, the oil shock triggered by the Iraqi invasion of Kuwait hastened the downturn by lowering consumer and business confidence and reducing disposable income.

The Federal Reserve has eased monetary conditions substantially since late October. This reflects a number of factors: evidence of growing weakness in the U.S. economy, moderating unit labour cost increases (which are well below those in Canada), and especially the evidence of banks' unwillingness to lend (which meant that credit conditions were tighter than appeared from interest rates alone). As a result of the easing in monetary conditions the recession is expected to be relatively brief and mild. Real GNP is expected to register two consecutive quarters of negative growth beginning in the fourth quarter of 1990, and virtually no growth in the second quarter of 1991, for a cumulative peak-to-trough decline of about 1 per cent.

Economic activity in the United States is projected to recover in the second half of 1991, with output growth rebounding at a fairly robust annual rate of 3½ per cent. Even so, real GNP for the whole year will show essentially no growth over its 1990 level (Table 1). Net exports are expected to be a major contributor to the recovery. This reflects the beneficial impact on U.S. competitiveness of the dollar's depreciation of more than 10 per cent over the past year, and sustained growth in a majority of overseas countries. Consumer spending is expected to recover later in 1991 as lower oil prices restore purchasing power and confidence. The Federal

Reserve Board has eased monetary policy in recent months, cutting the Federal Funds target rate by 1¾ percentage points since October. This will stimulate the interest-sensitive sectors of the economy, particularly housing, which appears to be poised to recover.

Inflation is projected to ease gradually during 1991 because of slack labour markets, excess manufacturing capacity, and declining oil prices. By 1992, it is projected to

Table 1

Short-term international economic prospects

	1990	1991	1992
	(per cent change unless otherwise specified)		
United States			
Real GNP	1.0	0.1	3.3
Final domestic demand	1.1	-0.5	1.8
CPI	5.4	5.1	3.7
Unemployment rate (per cent level)	5.5	6.5	6.2
Current account balance (billions of dollars)	-97.7	-93.1	-57.8
90-day commercial paper rate (per cent level, true yield)	8.3	6.7	7.7
AAA corporate bond rate (per cent level)	9.3	9.2	9.7
Other major OECD countries			
Real GNP/GDP			
Europe	3.2	2.3	2.7
western Germany[1]	4.5	3.4	3.0
France, United Kingdom, and Italy	2.0	1.3	2.4
Japan	5.5	3.6	3.8
Inflation			
Europe	5.2	5.3	4.3
western Germany[1]	2.7	3.8	3.5
France, United Kingdom, and Italy	6.0	5.7	4.5
Japan	3.0	3.2	2.2

[1] Projections for western Germany refer to the pre-unification Federal Republic of Germany.

fall below 4 per cent. As the recovery gathers strength and the strains of the financial system ease, short-term interest rates are expected to rise, averaging 7.7 per cent in 1992. Despite the October 1990 agreement between the White House and Congress on a deficit-reduction package, the federal deficit is projected to rise to $310 billion in fiscal 1991 (excluding the costs of military operations in the Gulf) from $220 billion in 1990. The projected $90 billion increase reflects the weak economic outlook and a substantial increase in spending for the Savings and Loan restructuring. The current account deficit is projected to decline substantially in the second half of 1991. In 1992, the current account deficit is expected to average under $60 billion, compared with almost $100 billion in 1990.

Growth in the major overseas OECD countries is expected to be slower in 1991 than in 1990 (Chart 12). Japan and the western part of Germany are forecast to grow the fastest again, while growth in France and Italy is expected to slow. Although the U.K. is in recession, growth is expected to recover in the second half of 1991. In 1992, growth will recover and become better balanced among the major countries of Europe and Japan. Inflation is expected to increase on average in 1991, but should moderate in the second half of the year and on into 1992 as lower oil prices and slower growth reduce inflationary pressures in overseas economies (Chart 13).

Chart 12
Real GDP/GNP growth in the United States and overseas economies

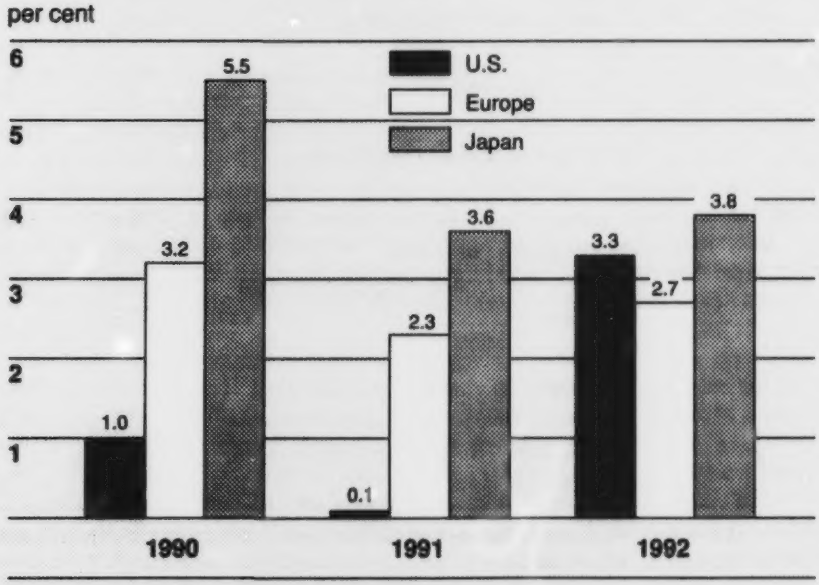
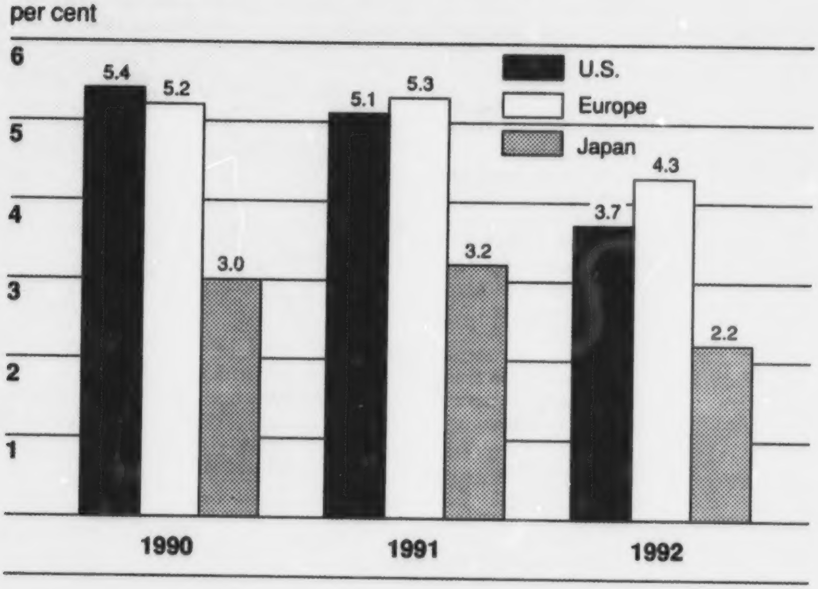


Chart 13
CPI inflation in the United States and overseas economies



Short-term economic outlook for Canada

Recession to continue until mid-1991

Details of the short-term economic outlook for Canada are provided in Table 2. The contraction that began in the second quarter of 1990 is expected to continue into the spring of this year. The expected cumulative decline in output of just under 2½ per cent is much less than in 1981-82, but significant compared with other recessions since the Second World War. Employment is expected to decline about 2¼ per cent in the recession, and the unemployment rate will rise slightly above 10 per cent by mid-year (Chart 14).

Final domestic demand is expected to decline by a cumulative 3.2 per cent (Chart 15). The decline will be most pronounced in interest-sensitive components: consumer spending and residential investment. Consumer spending is expected to decline a further 1.1 per cent in the first half of 1991. Housing starts are expected to reach a trough in the first quarter of 1991.

Business fixed investment is expected to decline through most of 1991 due to the deterioration of corporate balance sheets, the continuing squeeze on profit margins, and the low level of business confidence. These negative factors are expected to

Table 2
The Canadian economic outlook: Main economic indicators, 1990 to 1992

	1990	1991	1992
	(per cent change unless otherwise specified)		
Expenditures (volumes)			
Gross domestic product (GDP)	0.8	-1.0	3.5
Consumption	1.3	-1.1	2.6
Residential investment	-7.6	-16.4	15.9
Business non-residential investment	-3.0	-3.2	5.3
Machinery and equipment	-6.8	-6.8	5.7
Non-residential construction	3.0	1.7	4.8
Government expenditure	3.6	1.4	-0.7
Final domestic demand	0.6	-1.7	2.9
Inventory change (per cent of GDP)	-0.2	0.1	0.1
Exports	3.4	-1.9	5.2
Imports	0.0	-3.3	3.0
Net exports (per cent of GDP)	-1.3	-0.9	-0.3
Current account balance (billions of current dollars)	-16.6	-11.2	-7.6
Housing starts (thousands of units)	164.0	143.0	180.0
Prices and costs			
Annual average			
CPI	4.8	5.6	3.2
CPI excluding GST	4.8	4.3	3.2
CPI excluding food and energy	4.4	5.3	3.2
GDP deflator	3.2	4.4	2.7
Labour income per employee	6.6	5.0	3.2
Fourth-over-fourth			
CPI	4.9	4.8	3.0
CPI excluding GST	4.9	3.5	3.0
CPI excluding food and energy	4.2	4.6	2.9
Labour market			
Labour force	1.3	0.6	1.9
Employment	0.8	-1.5	2.1
Unemployment rate (per cent; fourth quarter level)	9.1	10.0	9.8
Incomes			
Real personal disposable income	1.6	-1.9	1.3
Corporate profits before taxes	-21.3	-1.6	29.1
Personal savings rate (per cent)	11.0	10.3	9.1
Financial market (per cent)			
90-day commercial paper rate			
Nominal	13.0	9.5	9.0
Real[1]	8.2	5.2[2]	5.8
Long-term industrial bond rate (Scotia McLeod average)			
Nominal	11.9	10.9	10.5
Real[1]	7.1	6.6[2]	7.3

[1] Real interest rates are defined as the nominal rates minus the percentage change in the consumer price index.

[2] Calculated using the CPI excluding the GST which is estimated to add approximately 1¼ per cent to inflation in 1991.

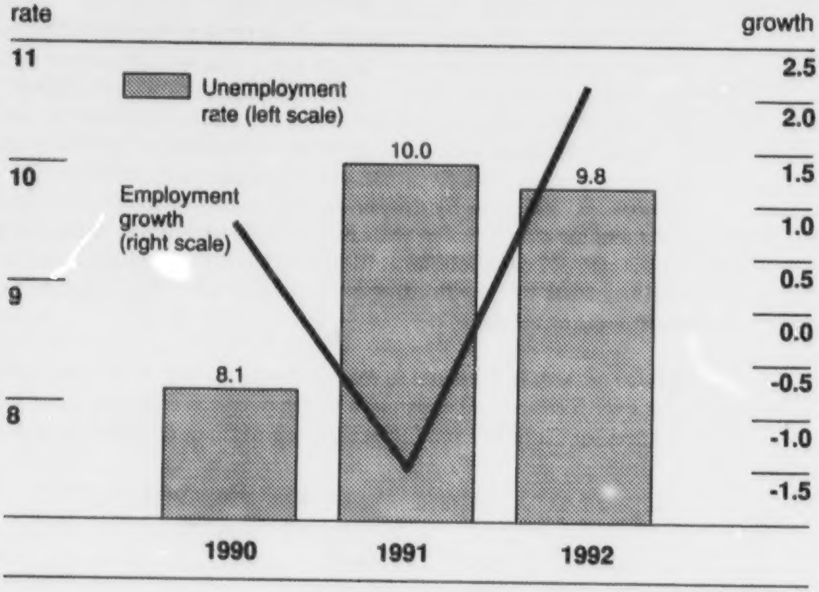


Chart 14
Canadian employment growth and unemployment rate

more than offset the impetus to new investment spending from the reduction in capital goods prices due to the removal of the Federal Sales Tax and the ongoing stimulus to investment spending from the Free Trade Agreement. Only energy-related investment is expected to increase in the near term, supported by commitments to major projects made before the Persian Gulf crisis.

Exports fell sharply in the second half of 1990, but should stabilize in the first half of 1991. Imports will continue to fall sharply in the first half of 1991, as domestic demand declines, but will resume growth in the third quarter.

Recovery gathers strength through 1992

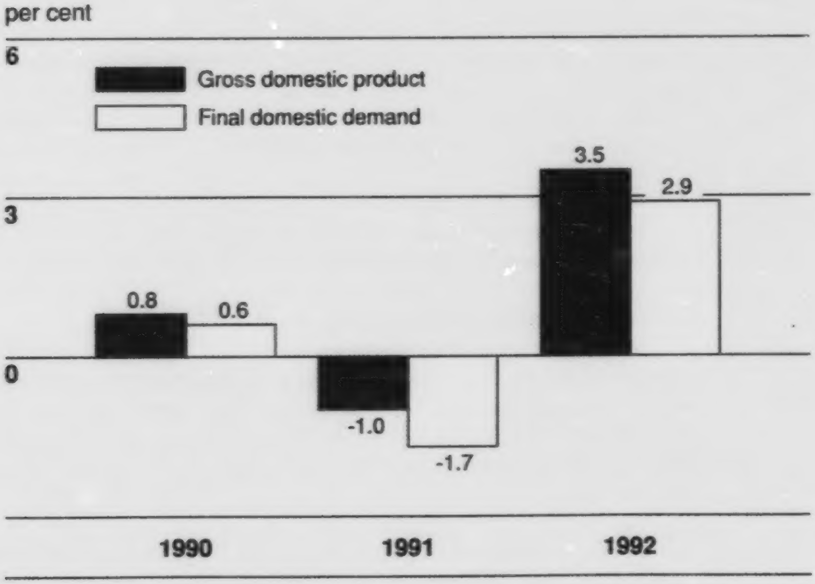
A substantial easing of domestic monetary conditions, along with a recovery in the United States and declines in oil prices, is expected to lead to a strong rebound in growth in the second half of 1991 and in 1992. Growth is expected to average 3.5 per cent in 1992. The recovery will originate in the trade sector and the interest-sensitive components of domestic demand, but become more broadly based by year-end.

Short-term interest rates are assumed to decline to an average 9.5 per cent in 1991, well below their 1990 average of 13 per cent but in line with current levels. They are expected to fall further to 9 per cent in 1992 (Chart 16). As domestic interest rates decline, the Canada-U.S. interest rate differential is expected to narrow. The decline in short-term interest rates, combined with a reduction in domestic inflation pressures, will bring the average long-term industrial bond rate down to 10.9 per cent in 1991 from 11.9 per cent in 1990.

The easing in monetary conditions, beginning in the second half of 1990 and accelerating through the first half of 1991, will spur growth in the interest-sensitive components of demand, directly by reducing borrowing costs and indirectly by increasing consumer confidence. Consumption is projected to rebound vigourously in the second half of the year, due to strong growth in spending on consumer durables. Residential investment will also increase, with housing starts reaching almost 160,000 units by the end of 1991 and close to 190,000 by the end of 1992. Demand for new housing will rise, reflecting lower financing costs and an increase in the rate of household formation due, in part, to higher immigration. Demographic requirements for new housing are expected to reach about 220,000 units a year from 1992 onwards.

Export growth is expected to resume by mid-1991. A recovery in the United States, along with continued expansion in the overseas economies, will strengthen the market for Canadian products; slower growth in domestic wages will improve

Chart 15
Growth in real GDP and real final domestic demand



competitiveness. In addition, there will be some movement from imports to domestically produced goods, in part due to the replacement of the Federal Sales Tax by the GST, which will remove the bias towards imports inherent in the old tax.

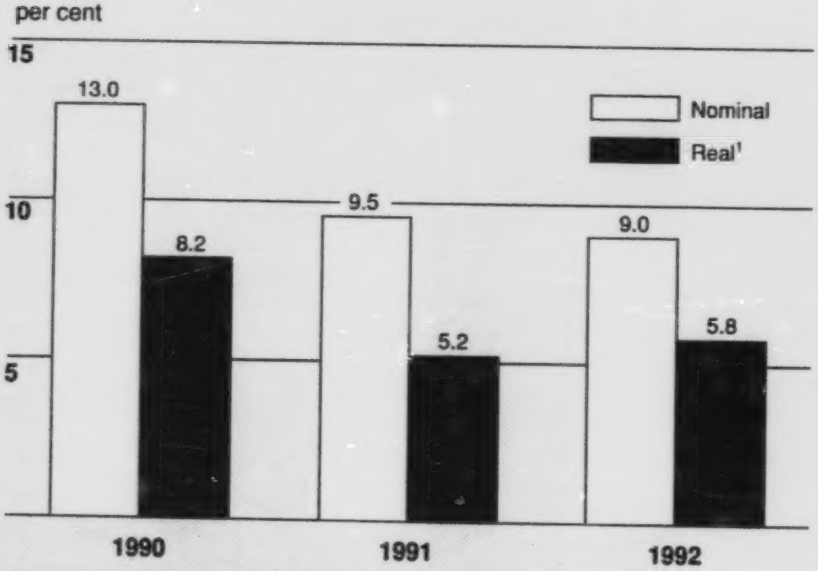
The increase in net exports will improve the current account balance and reduce our reliance on foreign savings. The current account deficit is expected to decline from $16.6 billion in 1990 to $11.2 billion in 1991 and $7.6 billion in 1992.

Business fixed investment will strengthen by year-end, as corporate financial positions improve and profit margins increase. Strong growth in investment spending through 1992 will raise the capital-output ratio and help lay the foundation for robust economic growth over the medium term.

As output strengthens, employment prospects will improve and the unemployment rate will decline. Employment growth is expected to resume in mid-1991, reaching 2.1 per cent in 1992. As a result, the unemployment rate will decline from its 1991 peak of about 10 per cent, but a cyclical increase in the labour force participation rate will keep it above 9½ per cent through 1992.

Chart 16

Nominal and real
90-day commercial paper rates



[1] Nominal rate minus CPI inflation.
In 1991, the one-time effect of the GST is excluded.

Inflation pressures to ease

The recent declines in economic activity have reduced real output below its potential level. This, along with the further output declines expected in the near term, will lead to a reduction in the rate of wage and price inflation (Chart 17). The impact on inflation expectations of this budget's actions for deficit reduction, fiscal reform and inflation targets will accelerate and deepen the response. Growth in the commercial wage rate is expected to slow from 6.1 per cent in the fourth quarter of 1990 to 4.7 per cent a year later. Together with a cyclical rebound in productivity, this will slow the growth in unit labour costs. The price competitiveness of Canadian products in world markets will improve and corporations will be able to start rebuilding badly damaged balance sheets.

The year-to-year CPI inflation rate is expected to be volatile early in 1991. Replacement of the FST with the GST will raise measured inflation, but the delay in passing the enabling legislation has made the actual timing of its impact quite uncertain. Throughout the year, however, inflation will moderate, falling to levels consistent with the government's inflation targets (see Chapter 5). Excluding food and energy, CPI inflation is expected to be just under 5 per cent at the end of 1991 and under 3 per cent by the end of 1992, in line with the government's inflation targets.

Chart 17

CPI inflation and growth in commercial wage rate

per cent – fourth quarter over fourth quarter

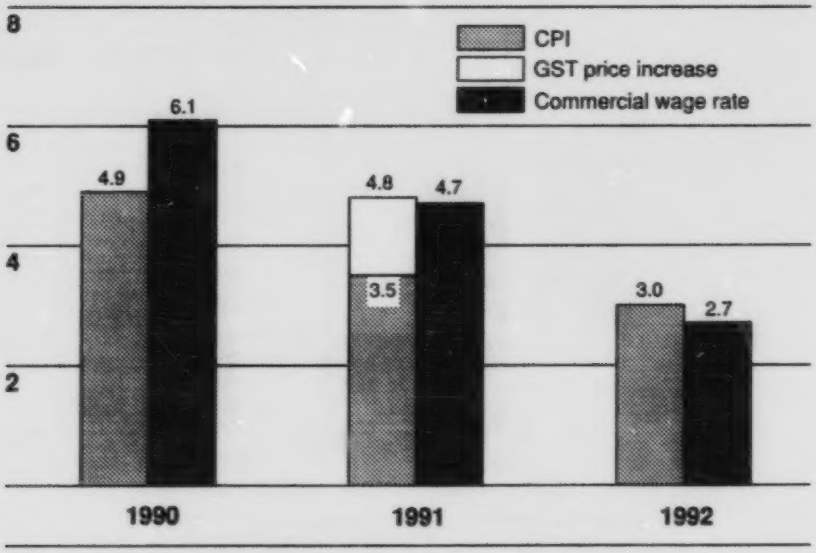


Chart 18a
Comparison with private sector forecasts for 1991

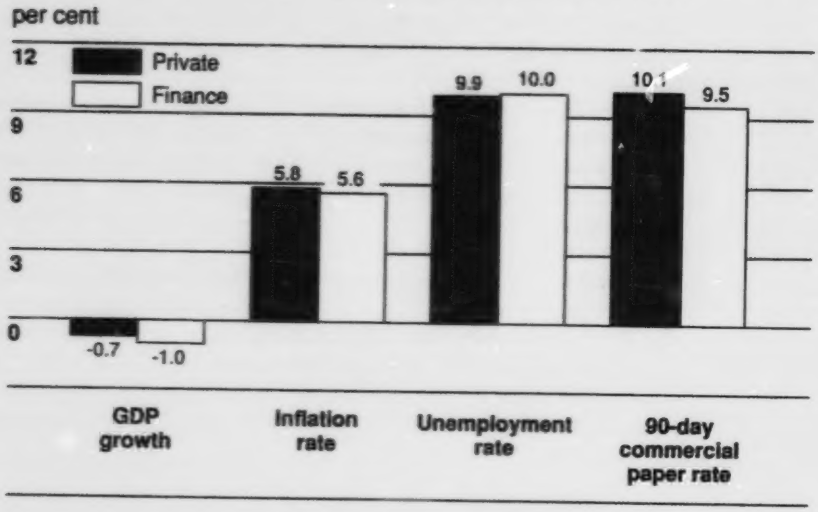
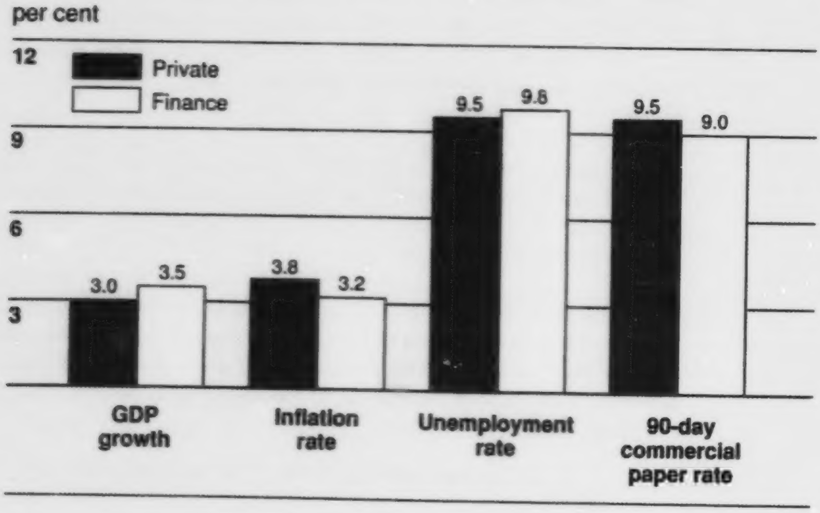


Chart 18b
Comparison with private sector forecasts for 1992



Canadian private-sector short-term forecasts

The Department of Finance regularly conducts surveys of private-sector forecasts. Charts 18a and 18b compare the Finance forecast with the consensus, or average, of 18 private-sector forecasts from our most recent survey, conducted in late January 1991. For each of the major economic indicators the private-sector consensus is close to the Finance forecast for 1991.

Both the Department of Finance and the private-sector consensus expect the contraction will continue through the first half of 1991 and that recovery will start in the second half of the year. For 1991 as a whole, the private-sector consensus expects output to decline 0.7 per cent and the unemployment rate to rise close to 10 per cent.

The weakness in product and labour markets is expected to moderate underlying inflation and bring a decline in interest rates, setting the stage for a recovery in the second half of the year. The consensus expects short-term interest rates to fall to 10.1 per cent in 1991 from 13.0 per cent in 1990. This is more moderate than the decline in the Finance projection. However, the private sector forecast survey was conducted in late January, when short-term interest rates were around 10¾ per cent.

Both the private-sector consensus and the Finance forecast show a strengthening of the economic recovery through 1992. The pace of the expansion in output is slower in the private-sector consensus, but the unemployment rate is slightly lower. Inflation declines somewhat less from 1991 to 1992 in the consensus forecast than in the Finance forecast.

CANADA'S MEDIUM-TERM ECONOMIC PROSPECTS, 1993-1996

Competitiveness is the key to Canada's prosperity in the medium and longer-terms. We must be able to deal with technological and competitive challenges in an increasingly competitive world economy. Controlling inflation is critical to create a climate conducive to increased competitiveness. Other government policies will also affect the overall efficiency and adaptability of Canadian firms at home and abroad.

As discussed more fully in Chapter 6, the government's Plan for Economic Recovery will help ensure an economic environment conducive to sustained and balanced growth, allowing Canadians to take full advantage of the structural reforms put in place over the last six years.

The main medium-term projections for the Canadian economy are provided in Table 3. They are based on the policy assumptions outlined in this document and healthy expansion in the economies of our major trading partners. It is important, however, to recognize that different assumptions could significantly alter the projections.

Structural reforms raise potential growth

The government's structural reforms, implemented since 1984, have helped raise the economy's potential growth rate from about 2¾ per cent during the 1980s expansion to a projected 3¼ per cent over the medium term. The potential growth rate is determined by the growth of labour, capital, and total factor productivity. Despite the ageing of the population, the Labour Market Development Strategy and increased net immigration will result in labour-force growth at an average annual rate of 2.1 per cent, up slightly from 1.8 per cent during the 1980s expansion. The Free Trade Agreement with the United States, deregulation of industries, and the effect of the GST will stimulate capital spending. The capital stock is expected to grow 4.4 per cent a year over the medium term, up from 3.5 per cent during the previous expansion. The structural reforms will also raise total factor productivity growth, which should average 0.5 per cent a year compared with virtually no growth during the 1980s expansion.

Table 3
Medium-term economic outlook:
Selected economic indicators, 1990 to 1996

	1990	1991	1992	Average 1993-96
	(per cent change unless otherwise indicated)			
Real GDP	0.8	-1.0	3.5	4.0
Real exports	3.4	-1.9	5.2	4.4
Employment	0.8	-1.5	2.1	2.7
Unemployment rate (%, fourth quarter)	9.1	10.0	9.8	7.5[1]
Unit labour costs	6.5	4.5	1.7	1.4
Inflation (CPI)[2]				
Total	4.9	4.8	3.0	2.2
Excluding food and energy	4.2	4.8	2.9	2.1
90-day commercial paper rate (per cent)				
Nominal	13.0	9.5	9.0	7.0
Real[3]	8.2	5.2	5.8	4.7

[1] Annual average for 1996.

[2] Fourth-quarter-over-fourth-quarter per cent change.

[3] Nominal rate minus CPI inflation rate excluding GST.

Sustained, balanced expansion in the medium term

Over the 1993-1996 period, real GDP is expected to grow at an average annual rate of 4 per cent, about three-quarters of a percentage point faster than potential. Despite this strong growth, capacity pressures are not expected to emerge, and this permits sustained declines in inflation. In line with the strong growth in output, employment is projected to grow at an average annual rate of 2.7 per cent, translating into more than one million new jobs from 1993 to the end of the forecast period. This, in turn, leads to a steady decline in the unemployment rate to 7.5 per cent by 1996.

Transition to permanently lower inflation

Typically, excess demand and eventually inflation pressures have characterized prolonged expansions. The government is committed to preventing a repetition of these damaging boom-bust cycles. As discussed in the chapter on Inflation Targets, the government is clarifying and reinforcing its commitment to price stability by setting intermediate inflation targets.

The inflation targets, together with the actions taken in this budget to achieve them, will encourage inflation expectations to adjust rapidly. This will make it easier and much less costly to achieve price stability. It will also help avoid the vicious circle of emerging cost pressures, rising interest rates, and economic weakness that has characterized past cycles. In this way, Canada can get on a virtuous circle of lower inflation, low interest rates and stable growth.

The underlying rate of inflation, as measured by the CPI excluding food and energy, is projected to fall to 2.9 per cent by the end of 1992, just under 2½ per cent by mid-1994, and below 2 per cent by the end of 1995. Such an achievement would not be unprecedented in Canada's postwar experience. Indeed, during most of the 1950s and the first half of the 1960s, inflation averaged well below 2 per cent annually. This was accompanied by strong real growth, which averaged about 5 per cent.

Steady progress in lowering inflation to the inflation targets will also create the appropriate economic climate for nominal and real interest rates to fall. As inflation expectations fall, so too will inflation premiums embedded in interest rates. The rate for 90-day commercial paper is projected to average 7 per cent over the medium term. The real interest rate – the nominal rate adjusted for inflation – is expected to average about 4¾ per cent. This is similar to the average of the 1980s and about 3 percentage points higher than the average of the 1960s and 1970s.

The drop in interest rates, combined with the Free Trade Agreement with the United States and the effect of the GST, will stimulate business investment. Growth in real business investment is expected to average 9.3 per cent over the 1993-1996 period. This will raise investment's share of output to about 15 per cent, compared with about 12 per cent in the 1980s. Lower interest rates will also encourage continued strong growth in residential investment. Housing starts are expected to average about 220,000 units over the period, broadly in line with demographic requirements.

Enhanced competitiveness and prosperity

Growth in unit labour costs is expected to average 1.4 per cent over the medium term as wage increases slow in response to a better inflation performance. In addition, labour productivity grows 1.3 per cent a year over the medium term, as a result of robust investment growth and the enhanced efficiency made possible by the government's structural reforms. This unit labour cost performance represents a dramatic improvement on the 6.5-per-cent increase in 1990, and is also significantly lower than the 2.9-per-cent growth projected for the United States, our largest trading partner. Canada's enhanced competitive position will be reflected in a strong trade performance; real exports are expected to grow at an average annual rate of 4.4 per cent. Combined with strong productivity growth, this will help raise Canada's living standards. Real GDP per capita is expected to rise 2.7 per cent annually.

The strong trade performance will steadily improve Canada's external balance. Further, as the government reduces its claim on domestic savings, more will be available to the private sector to finance the expected strong investment growth. Canada's reduced reliance on foreign savings will contribute to a fall in the current account deficit from 1.6 per cent of GDP in 1991 to zero on average over the 1993-1996 period (Chart 19).

Medium-term economic performance in historical perspective

The strong growth projected for the medium term is consistent with the comparable period of the previous expansion (Chart 20). Real GDP growth averaged 4.6 per cent a year from 1984 to 1987, almost 1¾ percentage points above the potential growth rate. For 1993-1996, real GDP is projected to grow somewhat more slowly: 4 per cent a year, or about three-quarters of a percentage point faster than potential.

While aggregate output growth is expected to be similar over the 1993-1996 period to that recorded from 1984 to 1987, there will be many differences in the overall performance of the economy. Much more of the growth will come from business fixed investment and the net trade balance than in the previous expansion, in which strong growth of consumption – both by households and governments – played a bigger role. Productivity performance will also be better. These differences in the composition of growth – more supply and less consumption – will contribute fundamentally to lowering inflation pressures and an improved competitive position internationally. The economy will therefore be in a much better position in 1996 than it was toward the end of the 1980s.

By 1996, Canadians, under this scenario, can achieve an economy with no government sector deficit, no current account deficit, no net reliance on foreign savings, and low inflation. This represents a return to the more balanced economic performance of the 1950 to 1973 period. In short, the conditions will have been set for sustained growth in prosperity rather than a repetition of the wrenching cycles that followed the unbalanced expansions of the 1970s and 1980s.

Chart 19
Sources and uses of savings, 1991 to 1996

per cent of GDP

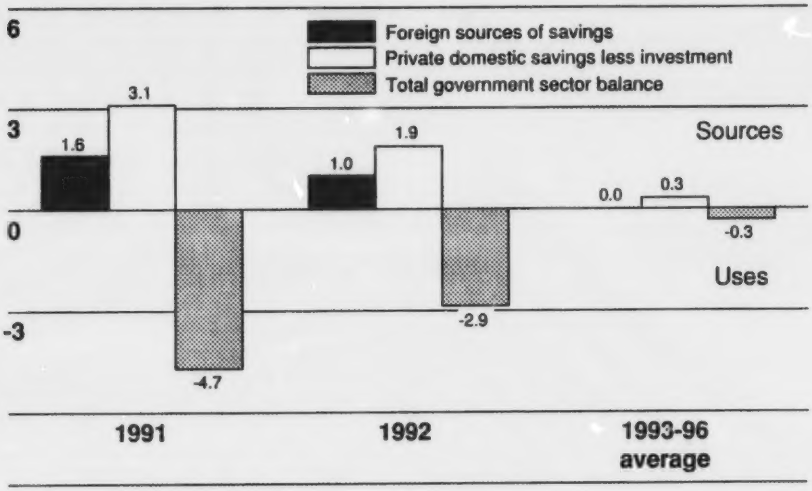
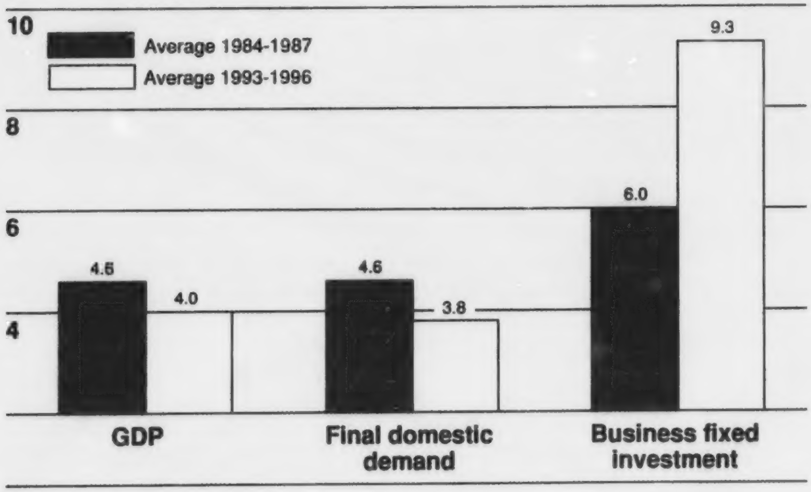


Chart 20
Real growth in output, domestic demand and investment

per cent – average annual



CHAPTER 3: EXPENDITURE CONTROL PLAN: A STRUCTURAL APPROACH

OVERVIEW

In this budget, the government is extending the Expenditure Control Plan introduced last year and is proposing fundamental structural reforms to provide greater assurance to Canadians that federal government spending will be controlled and carefully managed.

These reforms include legislated ceilings on program expenditures for the next five years and the establishment of a Debt Servicing and Reduction Fund. Program spending will be limited by law to not exceed the projections in this budget. The legislated Debt Servicing and Reduction Fund will receive the net revenues from the Goods and Services Tax, net proceeds from privatization, and earmarked contributions for debt reduction from individuals or businesses. These revenues will be applied first against the cost of servicing the debt and, as they grow over time, will be used to reduce outstanding debt. In combination with the proposed annual spending limits, this fund provides assurance that all revenues from the GST will be used to service and reduce the debt and not to fund new program spending.

The structural reforms build on the expenditure management strategy the government has followed since 1984.

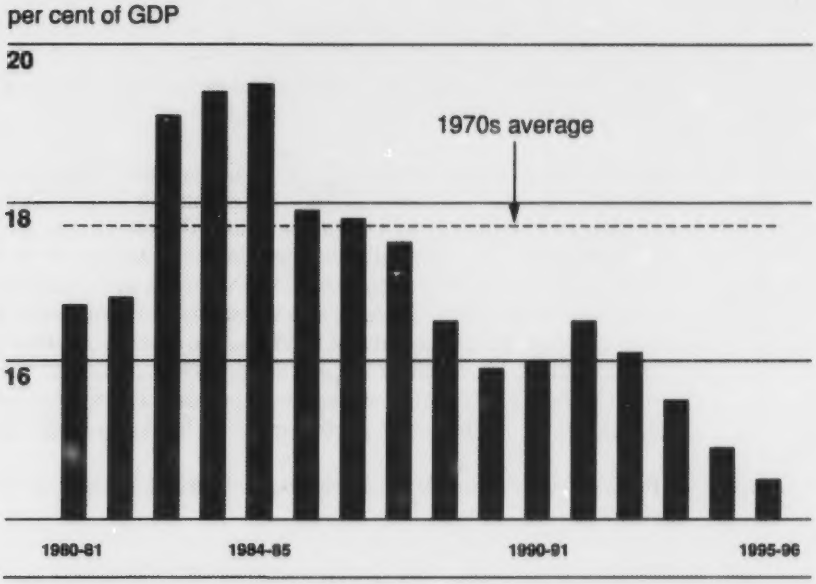
The government has made great progress in controlling expenditures over the last six years. In the 15 years before 1984-85, program spending had been increasing at an average annual rate of 13.8 per cent, or nearly 6 per cent a year in real terms. Since then growth has been held to 3.7 per cent a year, well below the average inflation rate of 4.4 per cent and less than half the rate of growth in the economy.

The resultant level of program spending as a proportion of the economy has declined from 19.6 per cent in 1984-85 to 16.0 per cent in 1990-91 (see Chart 1). Such levels were last witnessed in 1970-71. This decline of 3.6 percentage points in spending accounts for most of the 4.2 percentage point reduction in the deficit from its peak of 8.7 per cent of GDP in 1984-85 to 4.5 per cent in 1990-91.

In the February 1990 budget, to reinforce and extend this progress, the government introduced the Expenditure Control Plan for fiscal years 1990-91 and 1991-92. For about 40 per cent of all government spending on programs, this comprehensive, two-year approach reduced spending for both 1990-91 and 1991-92 below the level in 1989-90. The plan restrained the rate of growth in many other programs and exempted a limited number.

Developments in the past year again underscore the need to control debt build-up. With inflation pressures more entrenched than forecast a year ago, interest rates did not decline as projected. Debt servicing costs have been higher than expected and have put upward pressure on the deficit. As well, the economic downturn is proving to be deeper and more protracted than expected, resulting in lower revenues and

Chart 1
Program expenditures
1980-81 to 1995-96



higher program spending. Pressure on unemployment insurance payments has been particularly intense and depressed world grain prices have necessitated higher income support payments to the agricultural sector.

Without further fiscal restraint we would have even higher deficits and an increasing stock of debt. This would undermine confidence, put pressure on interest rates, and jeopardize the prospects for economic recovery.

The Expenditure Control Plan extension announced in this budget will continue to exempt certain programs, restrain the growth rate of several and reduce spending on others.

1. The following programs will be exempt:
   - major social transfer programs such as old age security benefits, family allowances, unemployment insurance benefits and Indian and Inuit programs;
   - certain major transfers to provinces such as equalization and Canada Assistance Plan transfers to equalization-receiving provinces; and
   - defence.

2. Growth rates will be restrained for the following:
   - Canada Assistance Plan transfers to non-equalization-receiving provinces will be subject to a growth ceiling of 5 per cent annually; and
   - science and technology programs and cash payments for Official Development Assistance will increase at 3 per cent annually.
3. The following programs will remain frozen:
   - per capita entitlements under Established Programs Financing;
   - payments under the *Public Utilities Income Tax Transfer Act*;
   - payments to the Canadian Film Development Corporation (Telefilm Canada); and
   - concessional loan financing of the Export Development Corporation.
4. Spending over the 1991-92 to 1995-96 period will be reduced through the following measures:
   - The total grants and contributions, largely to businesses and interest groups, not explicitly covered elsewhere in the Expenditure Control Plan will be reduced $75 million in 1991-92 and $125 million each year thereafter through 1995-96;
   - Canada Mortgage and Housing Corporation funding for new social housing will continue to be reduced by 15 per cent relative to planned levels;
   - Funds for the Canadian Jobs Strategy will be reduced $100 million in 1991-92; and
   - Funding for the Green Plan of $3 billion over the 1991-92 to 1995-96 period will be stretched out over the 1991-92 to 1996-97 period.
5. Spending on the costs of operating the government will be reduced in the following ways:
   - The government is not prepared to contemplate federal public sector wage settlements greater than 3 per cent a year for the next three years.
   - There will be no increase in departmental salary budgets in 1991-92 to compensate for wage contract settlements and there will be a maximum increase of 3 per cent a year in departmental salary budgets in each of the two subsequent years.
   - As a result, there could be up to 6,000 fewer public service jobs.
   - The non-wage operating and capital budget of the government will be frozen for 1991-92, followed by tight constraint on growth thereafter.
   - There will be a 10-per-cent reduction in the number of executives in government. Wage increases for the management category in the next three years will be no higher than the average of federal public sector negotiated settlements.

6. Management initiatives will be extended in the areas of cost recovery and improved tax compliance.

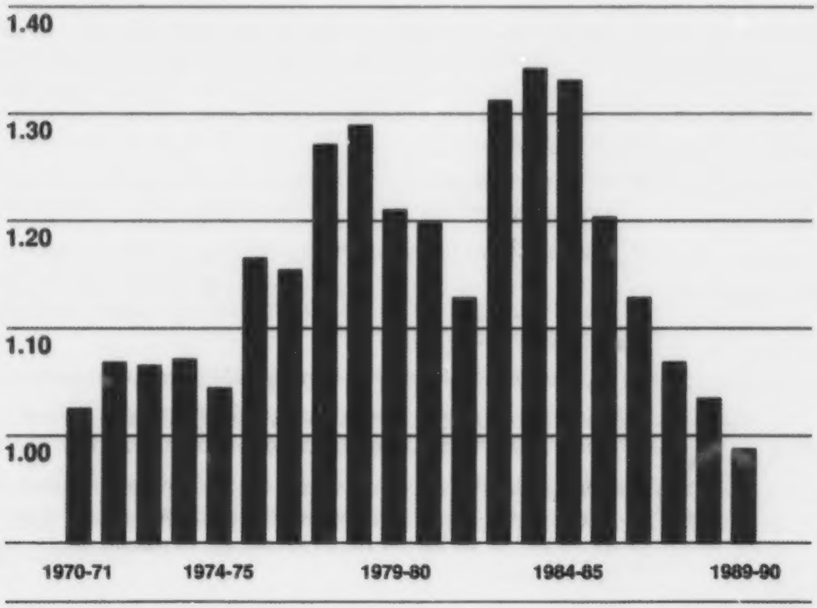
This chapter reviews the progress made in controlling government spending and describes the further actions being taken in this budget.

CONTROL OF PROGRAM SPENDING SINCE 1984

The context

The fiscal problem in 1984-85 was characterized by a basic structural imbalance between program spending and revenue. Program spending increased very rapidly during the 1970s and early 1980s. In an economy with low and faltering productivity growth, revenues were insufficient to fund the structure of program spending that was in place. By 1984-85, program spending exceeded budgetary revenues by $16 billion. Put another way: for each dollar that the government received from taxpayers, it spent $1.33 on programs (see Chart 2). The situation in the early 1980s stands in contrast to an approximate balance between program spending and tax revenues ten years previously.

Chart 2
Amount of government services for each tax dollar



Getting more than you pay for may seem attractive for a time. But all households know that there must be a day of reckoning when the bills come in. It is no different with the public sector. The shortfall of budgetary revenues relative to program spending had to be borrowed and as a result public debt began to escalate. In short, in the decade leading up to 1984-85, the government was offering Canadians a standard of government programs and services that was beyond the country's willingness to support – living on a credit card in effect. But the government, like everyone else, must eventually face the bills that were accumulating. The liability for these bills was simply being pushed into the future, and this liability was growing almost uncontrollably. By borrowing from future taxpayers to pay for services that it could not afford at the time, the government was lowering the prospective standard of living.

This imbalance between revenues and program spending had to be corrected. Since 1984, the government has followed a comprehensive strategy to do so. But the extent of the imbalance, along with the structure of program spending itself, constrained the scope for reductions and the timeframe within which substantial expenditure reductions could be achieved. Canadians had become used to receiving the benefits of a wide range of government programs at less than their true costs. Governments had become involved in areas that proved to be difficult to get out of. In short, there were no quick or easy fixes. A comprehensive and longer term approach to substantial reductions in program spending had to be adopted.

Actions to 1989

The government eliminated a wide array of federal programs between 1984 and 1989, including the Canadian Home Insulation Program, the Canadian Oil Substitution Program, and the Cape Breton heavy water plants. As well, the government reduced the rate of growth of federal transfers to the provinces and changed the structure of the Old Age Security and Family Allowance programs to recover those transfers from higher-income Canadians. The government also implemented sweeping structural reforms to the Unemployment Insurance Program. A number of transportation subsidies were scaled back, such as those to VIA Rail. Many Crown corporations were privatized, including Teleglobe Canada, Canadian Arsenals, Canadair, de Havilland and Air Canada. Other Crown corporations, such as Canada Post, have been put on a more self-sustaining basis. Many direct subsidies to business were reduced or eliminated, including the Defence Industry Productivity Program, the Petroleum Incentives Program, and the Canadian Exploration Incentive Program. The growth of defence spending and foreign aid was reduced. The cost of government operations was cut in real terms.

The Expenditure Control Plan in the February 1990 budget

In response to continuing strong fiscal pressures, the government launched the Expenditure Control Plan in the February 1990 budget. This Plan was a comprehensive two-year approach to expenditure reduction and control.

1. The Plan exempted certain programs from additional restraint:
   - major social transfers to persons; and
   - certain major federal transfers to equalization-receiving provinces.

2. Spending growth was limited to 5 per cent a year on:
   - science and technology;
   - Indian and Inuit Programs other than health, education, social assistance, and comprehensive claims;
   - Canada Assistance Plan transfers to non-equalization-receiving provinces;
   - Official Development Assistance; and
   - defence.

3. For the remaining 40 per cent of program spending the levels in both 1990-91 and 1991-92 were reduced to below that in 1989-90.

Results of expenditure restraint and control to 1990-91

Table 1 sets out the record on expenditure restraint and control over the 1984-85 to 1990-91 period. Over the six years, total budgetary expenditures increased an average 5.5 per cent a year. The cost of servicing the public debt grew on average by

Table 1

Budgetary expenditures: 1984-85 to 1990-91

	1984-85	1990-91	Absolute change	Annual average growth
	(billions of dollars)			(per cent)
Major transfers to persons	25.1	35.8	10.7	6.1
Major transfers to other levels of government[1]	18.8	23.3	4.5	3.6
(Cash and tax transfers to other levels of government)	(25.6)	(36.3)	(10.7)	(6.0)
Other major transfers	10.7	11.6	0.9	1.4
to business	4.7	3.6	-1.1	-4.3
to other groups	6.0	8.0	2.0	4.9
Payments to major Crown corporations	4.8	4.9	0.1	0.4
Defence	8.7	12.1	3.4	5.6
Official Development Assistance	2.1	2.6	0.5	3.5
Other program spending	16.8	18.0	1.2	1.2
Program spending	87.1	108.3	21.2	3.7
Public debt charges	22.5	43.0	20.5	11.4
Total budgetary expenditures	**109.6**	**151.3**	**41.7**	**5.5**

[1] Certain transfers to other levels of government are made as a combination of cash and a transfer of tax points.

11.4 per cent a year. By contrast, program spending – total spending excluding public debt charges – increased by only 3.7 per cent a year, much less than the 4.4 per cent average rate of inflation.

Chart 3 shows the structure of program spending in 1990-91 and Chart 4 shows the growth in the major components of program spending since 1984-85. Between 1984-85 and 1990-91, over 85 per cent of the increase in program spending has been concentrated in three areas – major transfers to persons, major cash transfers to other levels of government, and defence – but even these priority areas have not been immune from restraint.

Major transfers to persons

Major transfers to persons represent about 33 per cent of all program spending, the largest component of federal government program spending. These social transfers include the monthly old age security benefits, the guaranteed income supplement, spouses' allowances, family allowances, veterans' pensions and allowances, and unemployment insurance benefit payments. Half of all transfers to persons are directed to the elderly. The ageing of the population and full indexation of benefits

Chart 3
The structure of program spending: 1990-91

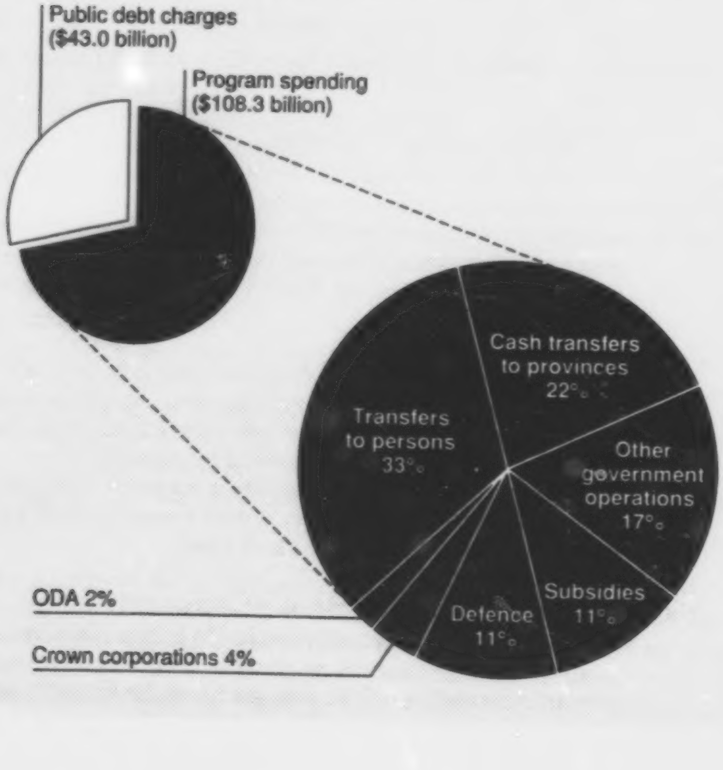
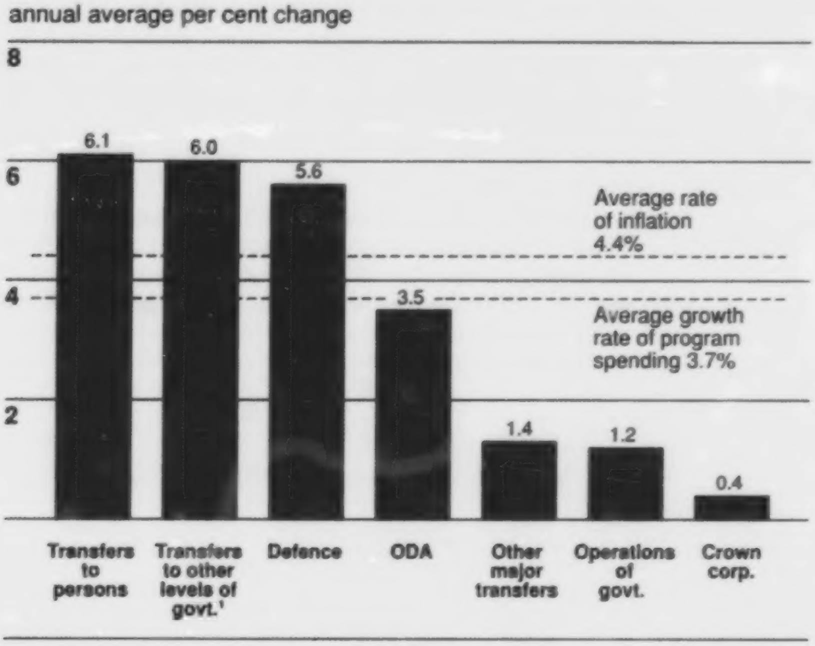


Chart 4
Growth in program spending
1984-85 to 1990-91



[1] Includes cash and tax transfers.

to inflation have made benefits to the elderly one of the fastest growing areas of government spending. The other major program in this area is unemployment insurance benefit payments. These payments are highly sensitive to changes in economic conditions.

Measures have been taken to moderate growth in these transfers. The unemployment insurance program has been changed to make it more effective. The government has limited the indexation of family allowances. As well, federal transfers for family allowance and old age security to higher-income Canadians are being fully repaid through the income tax system. Although this measure does not directly affect program spending, it does reduce the deficit and ensures that the benefits are better targeted than in the past.

Major transfers to other levels of government

The federal government will provide $36 billion this year to provincial governments to assist them in delivering programs and services for which the provinces have primary responsibility. This assistance is in the form of both cash and tax point transfers. Direct cash transfers to the provinces account for 22 per cent of federal program spending. These transfer programs are: Established Programs Financing (EPF), Equalization, and the Canada Assistance Plan.

Under Established Programs Financing, the federal government provides equal per capita financial assistance to all provinces through the transfer of tax points and cash payments. Historically, these transfers were undertaken to assist provinces to fulfil their responsibilities in health care and post-secondary education. Since block funding began in 1977, provinces have been able to use the money according to their own priorities, rather than in the more restricted way required by the previous cost-sharing arrangements. Prior to 1986, the total value of support, or entitlements, grew on a per capita basis in line with the growth in the economy. In the May 1985 budget, this growth rate was reduced by two percentage points. In the Expenditure Control Plan, introduced in the February 1990 budget, per capita entitlements were frozen for both 1990-91 and 1991-92.

The Equalization program provides provincial governments with funding to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. A ceiling on total Equalization payments, first introduced in 1982, is now limiting growth in total Equalization entitlements to the growth in the national economy. However, within this total, each province's Equalization reflects its relative financial circumstances. Overall, total Equalization payments have grown strongly in recent years, from $5 billion annually in 1984-85 to over $8 billion in 1990-91.

Under the Canada Assistance Plan, the federal government provides funds to provincial governments to help them pay for social assistance benefits and services. In the Expenditure Control Plan of the February 1990 budget, the government announced its intention to restrain growth in these transfers to the fiscally stronger provinces – Ontario, Alberta, and British Columbia – to 5 per cent a year for both 1990-91 and 1991-92. The federal government continues to share on a 50:50 basis costs of eligible provincial spending of those provinces receiving Equalization payments.

Other major transfers

As shown in Table 2, the federal government spent $11.6 billion in 1990-91 on other transfers to a wide range of recipients. This represented about 11 per cent of program spending. Of these other transfers, those directed to business were $1.1 billion lower in 1990-91 than in 1984-85, a 4.3 per cent annual rate of decline. However, notwithstanding these overall declines, support for industrial innovation and science and technology almost doubled over this period, and regional development funding was up significantly.

Most of the increase in the past six years was concentrated in transfers under Indian and Inuit programs and agricultural assistance, the latter mainly for grain farmers affected by low grain prices. Additional funding has also been provided for science and technology and regional development in the Atlantic provinces (through the Atlantic Canada Opportunities Agency), Western Canada (through Western

Table 2
Other major transfers

	1984-85	1990-91	Absolute change	Annual average growth
	(billions of dollars)			(per cent)
Total	10.7	11.6	0.9	1.4
of which				
Transfers to assist business				
Regional development	0.7	1.2	0.5	9.4
Industrial innovation and science and technology	0.8	1.5	0.7	11.4
Transportation	0.4	0.4	0.0	0.0
Energy	2.8	0.5	-2.3	-24.7
Total	**4.7**	**3.6**	**-1.1**	**-4.3**
Other transfers				
Agriculture and related subsidies[1]	1.6	2.6	1.0	8.4
Indian and Inuit	1.3	2.3	1.0	10.0
Student loans	0.2	0.5	0.3	14.4
Job creation	1.8	1.8	0.0	0.0
Other	1.1	0.8	-0.3	-5.2
Total	**6.0**	**8.0**	**2.0**	**4.9**

[1] Includes payments to railways under the *Western Grain Transportation Act* to subsidize the cost of transporting grain.

Economic Diversification), Quebec, and Northern Ontario. In contrast, energy subsidies have been cut. The Petroleum Incentives Program, the Petroleum Compensation Program, the Canadian Oil Substitution Program and the Canadian Home Insulation Program have all been eliminated. Financial contributions assisting business are now in large part repayable and not straight grants or subsidies.

Payments to major Crown corporations

The government has also cut the growth in transfers to major Crown corporations. Canada Post Corporation was made self-sufficient. The heavy water plants in Cape Breton were closed and passenger rail services were rationalized. In addition, subsidies to the Canadian Broadcasting Corporation have been scaled back, the funding for the Canadian Film Development Corporation (Telefilm Canada) and the concessional export funding activities of the Export Development Corporation have been frozen for both 1990-91 and 1991-92, and funds for new social housing by the Canada Mortgage and Housing Corporation have been reduced by 15 per cent from planned levels for both 1990-91 and 1991-92. Payments to major Crown corporations showed virtually no increase from 1984-85 to 1990-91, and now represent only 4 per cent of program spending.

Defence

Defence spending has grown faster than total program spending reflecting the government's priority on Canada's defence capabilities. Due to hostilities in the Gulf, additional funding has been provided in both 1990-91 and 1991-92.

Official Development Assistance

Between 1984-85 and 1988-89, assistance to developing countries, under Official Development Assistance (ODA), advanced at an annual average rate of 4.7 per cent. In the April 1989 budget, ODA cash levels were reduced and, under the Expenditure Control Plan introduced in the February 1990 budget, the annual rate of growth of ODA cash was limited to 5 per cent for both 1990-91 and 1991-92.

Other program spending

Other program spending primarily consists of non-defence and non-ODA personnel, operating and capital spending. This component has been constantly restrained since the fall of 1984. It accounts for about 17 per cent of program spending in 1990-91, down substantially from 19.2 per cent in 1984-85.

Between 1984-85 and 1990-91, the number of authorized person-years was reduced by more than 12,000 to the lowest level since 1973-74. Operating budgets have declined in real terms. This has been accomplished by requiring departments to absorb price rises in non-salary budgets. Capital spending has been reduced in the last six years, reflecting restraint measures.

Special Operating Agencies (SOA) are a major and successful government initiative in the promotion of better management of government services and improved cost-effective service delivery to the public. The five Agencies announced in December 1989 are now in place. They include the Canada Communication Group and Consulting and Audit Canada (Supply and Services), Training and Development Canada (Public Service Commission), the Passport Office (External Affairs) and the Government Telecommunications Agency (Department of Communications).

Results to date are highly encouraging. These Special Operating Agencies have already established high levels of service, devised more effective performance measurement techniques and improved overall management performance by delegating increased responsibility for operational actions to managers. In effect, they have been put on a more commercial basis.

Total program spending

Total program spending as a proportion of GDP has dropped from 19.6 per cent in 1984-85 to 16.0 per cent in 1990-91. Federal government program spending was last at such levels in 1970-71. If the ratio of program spending to GDP had not declined by 3.6 percentage points since 1984-85, the level of program spending would have been nearly $30 billion higher in 1990-91. With the compounding effect of interest payments, the deficit in 1990-91 would have been almost $70 billion.

Despite the actions to date, the fiscal situation requires further spending cuts. Economic events did not turn out as expected in late-1989 and 1990 – inflationary pressures remained entrenched throughout most of 1990 and, as a result, interest rates did not decline as early as had been forecast. The recession, through the impact on cyclically sensitive expenditures and revenues, has put additional upward pressure on the deficit. Without substantial additional expenditure reductions the deficit would continue to increase. A higher deficit and the associated higher debt would lead to further upward pressure on future deficits. This dynamic of higher debt service payments, higher deficits and debt and still higher debt service payments would delay economic recovery and put at severe risk the attainment of sustainable non-inflationary economic growth over the medium term.

EXTENSION OF THE EXPENDITURE CONTROL PLAN

Extension of the Expenditure Control Plan introduced in the February 1990 budget is a key element of the present budget. The main features of the Plan, as extended over the period covered by this budget are:

- The Plan is now a comprehensive medium-term approach to expenditure control; it yields substantial and ongoing fiscal savings. With economic recovery and reasonable growth, the extension of the Expenditure Control Plan will result in a budget with financial requirements in surplus beyond 1993-94.
- The Plan continues to exempt a limited number of programs: major social transfers (elderly benefits, family allowances, veterans' pensions and allowances, Indian and Inuit programs, and unemployment insurance benefits) and certain major transfers to the provinces (Equalization and Canada Assistance Plan transfers to equalization-receiving provinces). The Plan's exemption of major social transfers, combined with the recovery through taxation of benefits to higher-income individuals, will ensure the spending focus remains on those most in need. In light of the hostilities in the Persian Gulf, defence spending will not be subject to the extension of the Plan.
- The Plan continues through 1994-95 the ceiling of 5 per cent per annum growth on Canada Assistance Plan transfers to the non-equalization provinces.
- In line with declining inflation and the government's inflation targets, spending growth on science and technology and Official Development Assistance will be held to 3 per cent per annum beginning in 1992-93.
- Established Programs Financing (EPF) transfers to the provinces will be frozen in per capita terms through 1994-95, and thereafter will be constrained to a rate of growth of GNP less three percentage points.

- For all other program spending, amounting to about one-third of the total, spending will be tightly constrained over the 1991-92 to 1995-96 period. Significant reductions in the costs of government operations will contribute significantly to this restraint.

The next section gives details of the extension of the Expenditure Control Plan and Table 3 summarizes its fiscal impact.

The Expenditure Control Plan constrains the growth rate of federal transfers to the provinces, while providing relatively more support to the lower-income provinces. Entitlements under Established Programs Financing will be frozen in per capita terms and Canada Assistance Plan payments to non-equalization provinces will be allowed to grow at most by 5 per cent per annum. Equalization and Canada Assistance Plan payments to equalization-receiving provinces will continue to be exempt from the Expenditure Control Plan. As a result, the three major transfers to the provinces – Established Programs Financing, Equalization, and the Canada Assistance Plan – are expected to grow by about 3.7 per cent per annum from 1991-92 to 1995-96, compared to growth of 3.0 per cent per annum for total program spending. Average growth for the three highest income provinces will be about 3 per cent, for the equalization-receiving provinces the average growth will be over 4 per cent. Over the next five years these programs, even after restraint, will deliver nearly $183 billion of support (in cash and tax point transfers) to provinces compared with $150 billion in the previous five years.

Extension of the Expenditure Control Plan continues a freeze on the Public Utilities Income Tax Transfer, contributions to Telefilm Canada, and funds available for concessional export financing. Funding for new social housing will continue to be reduced from planned levels by 15 per cent in each year. Grants and contributions not specifically affected by the measures already described will be subject to a cut in aggregate of $75 million in 1991-92 and $125 million each year thereafter relative to existing reference levels. Labour force training funds under the Canadian Jobs Strategy will be reduced in 1991-92 by $100 million. Funding of $3 billion for the Green Plan will now be stretched out over six years rather than five years, delaying $600 million of expenditures over the 1991-92 to 1995-96 fiscal framework.

The government is also implementing a number of management initiatives affecting the operations of government. Wage compensation for the public service will be substantially restrained, the non-wage operating and capital budget is being frozen for one year, the collection of revenues and other monies owed the government will be improved, and new cost-recovery initiatives will be implemented.

The government's firm commitment to achieving the restraint set out in this budget is exemplified by its proposal to limit, by legislation, program spending over the next five years to the levels projected in this budget. As well, the government will propose legislation to create a Debt Servicing and Reduction Fund. Net GST revenues and certain other revenues will flow into this Fund to be credited against interest on the public debt. These two structural changes will provide Canadians with the assurance they seek that program spending will continue to be tightly managed and the GST revenues will not be used to finance new programs.

DETAILS OF THE EXPENDITURE CONTROL PLAN

The Expenditure Control Plan measures, together with associated savings in public debt charges, will save $1.2 billion in 1991-92, and $2.3 billion in 1992-93. The cumulative savings over the period from 1991-92 to 1995-96 total almost $15 billion (see Table 3).

A. Programs constrained

Science and technology

In the February 1990 budget, total funding for most science and technology grants and contributions was limited to an annual increase of 5 per cent for both 1990-91 and 1991-92. The programs included the Defence Industry Productivity Program, new programs under the Department of Industry, Science and Technology (such as Sector Campaigns and Strategic Technologies, the Canada Scholarships Program, and the Centres of Excellence programs) and grants and contributions associated with the National Research Council and the Canada Space Program. The Granting Councils, which provide support to university research, were not affected.

The present budget limits funding for all science and technology grants and contribution programs to annual increases of 3 per cent, beginning in fiscal 1992-93. The 3-per-cent annual increases will provide some $1.5 billion above existing spending levels for new or enhanced initiatives in support of science, technology, and competitiveness objectives to the end of 1995-96.

Canada Assistance Plan

Under the Canada Assistance Plan (CAP), the federal government provides for 50:50 cost-sharing with the provinces of eligible social assistance expenditures. Following a five-year period in which CAP transfers grew at an annual average rate of about 6½ per cent, the federal government announced last year that growth in CAP transfers was to be limited for 1990-91 and 1991-92 to 5 per cent a year in the fiscally stronger provinces – Ontario, Alberta, and British Columbia. Other provinces – those receiving federal equalization payments – were exempt from this ceiling.

Measures will be introduced to extend the 5 per cent annual growth ceiling for non-equalization-receiving provinces through 1994-95; thereafter, for planning purposes, it is assumed that CAP expenditures in these provinces will grow roughly in line with increases in GNP. Equalization-receiving provinces will continue to have unconstrained access to federal funds to meet all their expenditures eligible for CAP cost sharing.

Official Development Assistance

The 1990 budget limited the growth in cash disbursements under Official Development Assistance (ODA) to 5 per cent annually in both 1990-91 and 1991-92. The government also stated that the principle of funding ODA at a percentage of GNP would be maintained. The ODA-to-GNP ratio, which is affected by the levels of both cash and non-cash ODA, was expected to increase in each year, reaching 0.47 per cent by fiscal 1994-95.

Table 3
Fiscal impact of expenditure measures announced in this budget

	1991-92	1992-93	Five-year savings (i.e. through 1995-96)
		(millions of dollars)	
A. Expenditure Control Plan			
1. Key exempt programs			
Major transfers to persons: old age security, guaranteed income supplement, spouses' allowances family allowances, veterans' pensions and allowances and unemployment insurance benefits			
Major transfers to provinces: Equalization and Canada Assistance Plan for the equalization-receiving provinces			
Defence			
Indian and Inuit programs			
2. Programs constrained			
Canada Assistance Plan for non-equalization-receiving provinces		365	2,135
Official Development Assistance[1]		262	1,610
Green Plan funding from 5 to 6 years	125	100	600
3. Programs frozen			
Established Programs Financing		338	2,340
PUITTA		48	311
Canadian Film Development Corporation		7	28
Export Development Corporation		25	100
4. Programs reduced			
Grants and contributions	75	125	575
Canada Mortgage and Housing	32	71	411
Canadian Jobs Strategy	100		100
5. Management Initiatives			
Operating budgets	685	720	3,640
Increased tax compliance/cost recovery	50	53	1,009
Proceeds from privatization	60		60
B. Expenditure Control Plan savings	1,127	2,114	12,919
C. Associated public debt charge savings	50	200	1,900
D. Total fiscal impact of measures	1,177	2,314	14,819

[1] Includes fiscal savings related to the wind-up of Petro-Canada International Assistance Corporation (PCIAC).

Owing to the seriousness of the fiscal situation, ODA cash will be constrained to growth of 3 per cent a year in fiscal 1992-93 and following years. In addition, an International Assistance Envelope has been introduced to fund ODA and other international assistance initiatives such as assistance to Eastern Europe. This approach is designed to improve fiscal planning and control by balancing the available resources against the total demands for international assistance.

ODA funding consists of both ODA cash and elements outside the ODA cash level. These elements which are expected to increase sizeably, will be affected by the following factors, among others:

- the pace and magnitude of debt relief agreed upon multilaterally for ODA-eligible countries undertaking approved economic reform programs;
- the disbursement schedule of concessional financing for projects in ODA-eligible countries;
- the speed with which international environmental agreements affecting ODA-eligible countries are concluded; and
- the profile of Canada's commitments to multilateral aid agencies, such as the International Development Association and the regional development funds.

On the basis of likely growth in both ODA cash and these other elements, the government still expects to achieve an ODA-to-GNP ratio of 0.47 per cent in 1994-95.

Green Plan

The government demonstrated its strong commitment to environmental action with the announcement of the Green Plan in December 1990. The Plan was announced as $3 billion over the five years from 1991-92 to 1995-96, making it the largest new spending commitment announced since the government returned to office in 1988.

Since the Green Plan was announced, the economic situation has deteriorated with a consequent impact on the deficit. Given the imperative of restoring health to the fiscal situation, the government has concluded that the time period for the Green Plan should be extended from five to six years. This will slow the rate of new spending in the initial years, but assures that the total funds for the Green Plan will be preserved.

B. Programs frozen

Established Programs Financing

Established Programs Financing transfers are the largest single source of federal assistance to provinces; they have grown from $14.5 billion in 1984-85 to over $20 billion in 1990-91.

The freeze on per capita EPF entitlements announced in the February 1990 budget for 1990-91 and 1991-92 will be extended to 1994-95. This means that total EPF entitlements will continue to grow in line with the increase in population of each province. In 1995-96, growth in EPF entitlements will be constrained to a rate of growth of GNP less three percentage points.

In addition to EPF, the federal government provides substantial assistance to the lower-income provinces through the Equalization program to help them provide public services, including health care and post-secondary education. Equalization transfers amount to over $8 billion in 1990-91. Equalization transfers are not affected by the extension of the Expenditure Control Plan.

The *Canada Health Act* authorizes the federal government to withhold EPF cash payments from any province not in compliance with national conditions and criteria of health care. Concerns have been raised about the federal government's future ability to enforce the *Canada Health Act*. To allay these concerns, the federal government will be amending the *Fiscal Arrangements Act* so that, if necessary, other cash transfers to provinces could be withheld for purposes of enforcement. The conditions and criteria governing medicare will not change. Indeed, this action will strengthen the government's ability to uphold the conditions and criteria which govern the national medicare system.

It is recognized that the system of federal provincial transfers merits examination and review. Over the past year, discussions have been held with the provinces on a wide range of issues relating to the future of federal-provincial fiscal arrangements, including both major transfers and tax issues.

With respect to the transfer system, a process has been agreed to with the provinces to move these consultations further. The federal government will be discussing extensively with the provinces potential reforms to the major federal-provincial transfers (Equalization, Established Programs Financing and the Canada Assistance Plan). The purpose of these reforms is not only to adapt the transfers to the economic and fiscal circumstances of the 1990s, but to examine whether they can be made more effective in addressing the national needs and priorities of Canadians. Discussions on the updating and renewal of the Equalization program are already well under way, and will be carried forward as an integral part of this broader reform effort. Individual Canadians also have an important stake in these reforms, and the government will announce in due course a process for hearing their views as well.

On tax issues, the federal government intends to release a discussion paper in April 1991, on the Income Tax Collection Agreements. The paper will explore possible reforms to the Agreements to enhance the flexibility they offer provinces in the design of their income taxes while maintaining the real competitive benefits to the Canadian economy of simplicity for taxpayers and consistency in the structure of the federal-provincial tax system. This paper will provide a framework for a process of public consultation with individual Canadians, interested groups and tax professionals over the spring and summer months. On the basis of the advice received through these consultations, the federal government will resume discussions with the provinces in the fall to determine the degree of flexibility in provincial income taxes that can be most appropriately accommodated under the Income Tax Collection Agreements.

Beyond these transfer and tax issues, all governments in Canada at present face a difficult challenge managing deficits, debt loads and spending pressures while maintaining vital public services. The federal government and the provinces have agreed to cooperate on a joint study of the significant program cost pressures they will face over the 1990s, including such issues as duplication, overlap and government efficiency. This work, along with the study that the Prime Minister has asked the Economic Council of Canada to undertake on the impact of the size, cost and growth of government on the competitiveness of the Canadian economy, will help all governments work together to meet the competitiveness challenge of the 1990s.

Public Utilities Income Tax Transfer Act

The *Public Utilities Income Tax Transfer Act* provides for the transfer to the provinces of 95 per cent of the federal income tax collected from privately owned electric and gas utilities. The February 1990 budget froze these transfers at their 1989-90 levels.

As part of the Expenditure Control Plan, these transfers will remain frozen at their 1989-90 level through 1995-96.

Telefilm Canada (Canadian Film Development Corporation)

Telefilm Canada assists the Canadian film and television industry to finance the production and distribution of Canadian films and television programs. Funding of Telefilm Canada has been $146 million a year since 1989-90. Annual payments will continue to be frozen at that amount through 1995-96.

Concessional export financing

The Export Development Corporation provides insurance, loans and guarantees to support Canadian exports. It also administers export insurance and financing for the Canadian government to support export transactions considered to be in the national interest, but involving credit risks or interest-rate concessions the Corporation would not normally undertake.

The Corporation's budgetary reference levels, which finance concessional export credit financing and EDC equity infusion, will remain frozen at their 1989-90 levels through 1995-96.

C. Programs reduced

Grants and contributions

Other transfer payments, excluding the major transfer payments to persons and other levels of government, amount to $11.6 billion in 1990-91. The largest portion of these transfers, or grants and contributions, go to provide assistance to Indian and Inuit peoples, to farmers to stabilize and protect farm incomes, to encourage regional development, to develop job skills and to support research and development.

The Expenditure Control Plan exempts grants and contributions to Indian and Inuit peoples. Grants and contributions relating to science and technology will grow by 5 per cent per year in both 1990-91 and 1991-92 and by 3 per cent per year thereafter. A number of other grants and contributions which are statutory in nature such as student loans and payments under the *Western Grain Transportation Act*, are not affected by the Expenditure Control Plan. Grants and contributions under the Canadian Jobs Strategy program are being reduced by $100 million in 1991-92.

All other grants and contributions in this category amount to about $2.5 billion. This funding will be reduced by $75 million in 1991-92 and by $125 million each year thereafter. The Government House Leader and Vice-Chairman of the Treasury Board will be consulting with Ministers responsible for the various programs affected to ensure that spending reductions reflect government priorities and minimize disruption for the public.

Social housing

Canada Mortgage and Housing Corporation provides funds to provinces and territories under a variety of cost-sharing arrangements to assist Canadians who have difficulty finding affordable housing. Expenditures of $1.9 billion on social housing in 1991-92 will assist approximately 650,000 households. Funding for new social housing commitments is $86 million in 1991-92.

The 15-per-cent reduction in planned funds for new social housing, announced in last year's budget as part of the Expenditure Control Plan, will be continued through 1995-96. In addition, initiatives will be introduced to improve management of social housing and yield further ongoing savings. These measures include financing social housing projects through bulk tenders, and amortizing the cost of capital improvements.

D. Management initiatives

Operating budgets

Since the fall of 1984, the government has fundamentally changed the manner in which it manages human and financial resources. Management initiatives have been adopted to:

- restrain the costs of operations;
- improve management practices;
- find better ways to deliver programs;
- emphasize results-oriented management; and
- improve the management and development of people in the public service.

This budget sets out a number of additional initiatives intended to further improve efficiency and control spending on government operations. These will have the following implications:

- The non-wage operations and capital budget of the government will be frozen for 1991-92, followed by tight constraint on growth thereafter.

- Departmental operating budgets will not be adjusted for any increase in wage costs resulting from new negotiated collective agreements in 1991-92. This freeze means that departments will have to absorb any such higher costs from within existing budgets.

The Treasury Board will continue its responsibility for any reallocations that may be needed to adjust budgets to changing circumstances and priorities.

Within the context of this freeze, the Treasury Board will remain responsible for managing a small operating reserve to ensure that urgent and essential matters of health, safety and security are not impaired. Thus, even additional budgeted spending to provide for health, safety and security will not increase the total spending of the government.

To encourage efficiency, layers of management will be eliminated and the number of executives in the public service will be reduced by 10 per cent, or a minimum of 475 jobs.

The government will continue to seek an agreement with the public service unions through the National Joint Council on a Workforce Adaptation Policy that will permit the contracting out of government services. Should agreement not be achieved through negotiation, the government is prepared to introduce the necessary legislation to remove barriers to contracting out.

Public sector wage restraint

As a leading employer, the government has a responsibility to ensure that public sector wage settlements do not add to inflationary pressures in the economy. Since taking office in 1984, the government has exercised restraint in federal contract settlements while maintaining the principles of fair collective bargaining. Federal wage settlements have been lower than those concluded in the private sector, and lower than settlements agreed to by provincial and municipal governments.

Given the seriousness of the present fiscal situation and the continuing priority that must be attached to deficit reduction, the government believes it must exercise restraint in concluding wage settlements with its own employees. This does not mean singling out the public service for restraint. Rather, it is a matter of asking the public sector to recognize the difficulties faced by all Canadians during the present recession, and of asking the public sector to do its part in sharing the burden of fiscal restraint.

The government will continue to bargain with its employees. But as any employer would do, it will at all times be cognizant of its bottom line as dictated by the seriousness of the federal fiscal situation. The deteriorating deficit situation dictates that for the next fiscal year, available resources simply will not allow the government to increase operating budgets to compensate for wage and salary increases. This means that any wage increases resulting from the collective bargaining process will have to be funded through a corresponding reduction in public service employment. With a public service workforce of approximately 215,000, each increase of 1 per cent in pay could lead to a loss of approximately 2,000 jobs.

To contain the loss of public service employment and to ensure continuation of the provision of vital public services to Canadians, the government is not prepared to contemplate wage settlements exceeding 3 per cent a year over the next three years. Negotiated settlements of 3 per cent are consistent with this environment of severe restraint and are in line with the government's inflation targets. The alternative to a firm wage bargaining stance would be much deeper reductions in public sector employment, including lay-offs.

Rates of salary increase for the management category in the federal public service, Deputy Ministers and heads of Crown corporations will be limited to a level no higher than the average of federal public sector negotiated settlements.

The government believes it is important to maintain an effective working relationship with the public service unions, notwithstanding the demands of restraint, and it will ensure that arbitrators and conciliators are fully apprised of the employment consequences of excessive third-party awards. Should it prove necessary, however, the government will not hesitate to use legislative means to avoid excessive wage settlements or third-party awards. Nor will the government hesitate to use legislation to prevent work stoppages that would hinder the delivery of services to Canadians.

Details of this program of public sector restraint will be announced shortly by the President of the Treasury Board, who will be responsible for its administration. The program will generate savings of $685 million in 1991-92; ongoing savings will extend into the medium term.

Pay restraint is also needed in the provincial and local sectors. Some provinces have already introduced programs to limit the pay increases of their employees. It is vitally important, for both economic and fiscal reasons, that all provinces participate in a comprehensive and responsible wage restraint program. An easing of wage pressures in the private sector would also have beneficial effects. The lower the cost pressure throughout our economy, the lower interest rates will be able to go and the stronger will be our ability to increase economic activity and jobs.

Tax compliance and cost recovery

Revenue Canada (Taxation) will take steps to improve the collection of revenues owed to the government. Changes will be introduced to permit the recovery from tax refunds of monies owing to the government. New cost-recovery measures will be developed in the areas of border crossings and transportation services.

Crown corporations and agencies

Since 1984, the government has privatized or dissolved more than 20 Crown corporations and improved operations of the remaining. Through productivity gains, privatization and rationalization, the number of Crown corporation employees has been reduced by close to 80,000 since 1984-85.

In the coming year, the government will continue its objective of divesting itself of investments no longer required as instruments of public policy, and of letting market forces take the initiative to enhance Canada's competitiveness. In this context, the government is announcing in this budget its intention to sell CN Exploration, a subsidiary of CN. The necessary steps will also be taken to dissolve the Petro-Canada International Assistance Corporation (PCIAC) and the Canada Oil and Gas Lands Administration. Legislation will soon be introduced to enable the government to proceed with the sale of its 53-per-cent share in Telesat Canada as announced in last year's budget.

Proceeds from these initiatives will contribute to the deficit-reduction efforts in 1991-92.

Petro-Canada International Assistance Corporation (PCIAC), which was established in 1981 to assist developing countries to reduce or eliminate their dependence on imported oil, is a subsidiary of Petro-Canada. Its 1990-91 appropriations were $53 million.

PCIAC will be wound up and Canadian foreign aid will continue to be delivered in the energy sector through the Canadian International Development Agency (CIDA). This will rationalize Canada's energy aid.

CN Exploration, a small oil and gas exploration company, was created as a subsidiary corporation to exploit CN's mineral rights in Saskatchewan. CN Exploration's mandate currently limits its activities to exploration only on CN lands. The sale of CN Exploration will provide the company additional freedom to expand its operations and will not inhibit CN's ability to deliver its public policy mandate. The proceeds from the sale will be remitted to the government to reduce the deficit.

The efficiency of government operations will be further enhanced by merging some organizations and by putting some government operations on a more commercial basis.

Privatization efforts to date have streamlined the federal government's portfolio of Crown corporations. The privatization program, implemented by the government through the Office of Privatization and Regulatory Affairs (OPRA), has already moved more than 20 Crown corporations and other corporate holdings to the private sector and other levels of government. In keeping with the desire to streamline the operations of government, the Office of Privatization and Regulatory Affairs will be redeployed, with the functions and resources directed to the Department of Finance and the Treasury Board. The management of the government's future privatization efforts will be undertaken by the Department of Finance.

The government proposes to extend the use of Special Operating Agencies to more organizations, particularly those that are involved in providing services to the public and to departments. Such action will yield significant improvement in the delivery and cost-effectiveness of those services by setting more demanding performance targets and monitoring performance.

The following organizations, which include a number of candidates providing direct service to Canadians and which can be successfully commercialized through the application of private sector management techniques and cost recovery, will be converted to Special Operating Agency status:

- Canadian Grain Commission;
- Race Track Supervision; and
- Intellectual Property Directorate.

Further candidates for conversion to Special Operating Agency status, both ones with a commercial orientation as well as those of a purely service focus, will be announced by the President of Treasury Board in due course.

LEGISLATED SPENDING LIMITS

The expenditure restraint measures in this budget will keep the growth rate of program spending to an average 3 per cent a year from 1991-92 to the end of 1995-96.

In addition to the controls that have been put on many of the major spending categories, the government wishes to provide Canadians greater assurance that the projection of program spending will not in fact be exceeded. That is why the government is proposing to legislate limits on total program spending.

Legislated limits on total program spending will alter the fiscal operations of the government. Such limits, by putting legislated upper bounds on program spending, will give taxpayers greater assurance their tax dollars are handled efficiently and prudently. In designing the legislation, it will be important to ensure that the controls put in place do not unduly impinge upon the efficiency or effectiveness of government operations. It will also be important to protect the government's ability within the overall restraint of the spending limits to provide assistance to those most in need.

These and other issues associated with the proposal raise important questions of design and detail. Public input will be very important in determining how these issues are addressed in final legislation. Draft legislation will be available shortly for public review. Final legislation will be tabled in the fall after consultations with Canadians. In the meantime, however, the basic thrust of legislated spending limits can be indicated.

Legislated spending limits would in effect ensure that cumulative program spending over the 1991-92 to 1995-96 period could not, except in a limited set of prescribed circumstances, exceed the projections in this budget. If expenditure on a program rose above the projection – for economic or policy reasons – it would have to be offset by reductions elsewhere. The legislation would not allow increased borrowing or increased taxes to fund higher-than-projected spending.

The legislated limits would provide some flexibility for reallocation of spending between years in order to be manageable. Program spending could exceed the legislated limit in a particular year but to ensure that cumulative spending from

1991-92 to 1995-96 is not exceeded, the difference would have to be made up in other years.

A limited set of contingencies would have to be exempt from the spending limits. For example, expenditures would be permitted to exceed the limit because of a disaster (such as an earthquake) or a major external shock (such as a war). The legislation would not require such over-spending to be offset in other years. Final legislation would be explicit with respect to such contingencies.

As well, the legislated limits for program spending would not constrain expenditures on identified programs that are self-financing through premiums, if spending on these programs were to vary from the projections set out in this budget. Such specific self-financing programs would be limited to those such as Unemployment Insurance, the Gross Revenue Insurance Plan and the Net Income Stabilization Account, which contain self-financing provisions that by law explicitly operate to neutralize the impact of any over-spending on the deficit within a reasonable period of time.

To ensure accountability, each year's budget and Main Estimates would set out an update of program spending relative to the legislated limits. Any budget or Main Estimates that did not comply with the legislation could only be enacted by specifically amending the legislation.

Legislated spending limits will provide the assurance that higher taxes, including the Goods and Services Tax, will not be used to finance higher-than-projected or new spending on programs. This spending control will be critical to meet the fiscal targets.

The government will soon announce details of the process for public consultations leading to legislation next fall. The annex to this chapter summarizes the broad parameters of how that legislation could be designed.

THE DEBT SERVICING AND REDUCTION FUND

The Goods and Services Tax, aside from raising the output potential of the economy by removing the distortions inherent in the Federal Sales Tax, will provide greater assurance that the revenues required to meet the government's deficit objectives are available, since it will minimize tax avoidance and evasion.

The Prime Minister has given a commitment that any above-projected revenues from the GST will make a contribution to deficit reduction rather than provide the leeway for an expansion in discretionary government spending.

To implement this commitment, the government will introduce legislation to establish a specified purpose account, to which will be credited net GST revenues and from which will be debited public debt charges. Also credited to this account will be gifts to the Crown earmarked to debt reduction, and proceeds from privatization (see Chapter 4, Table 4). The Debt Servicing and Reduction Fund (DSRF) will be audited annually by the Auditor General.

The DSRF and legislated spending caps will give complete assurance that GST revenues go to deficit and debt reduction, not new spending, and that program spending is effectively constrained and controlled.

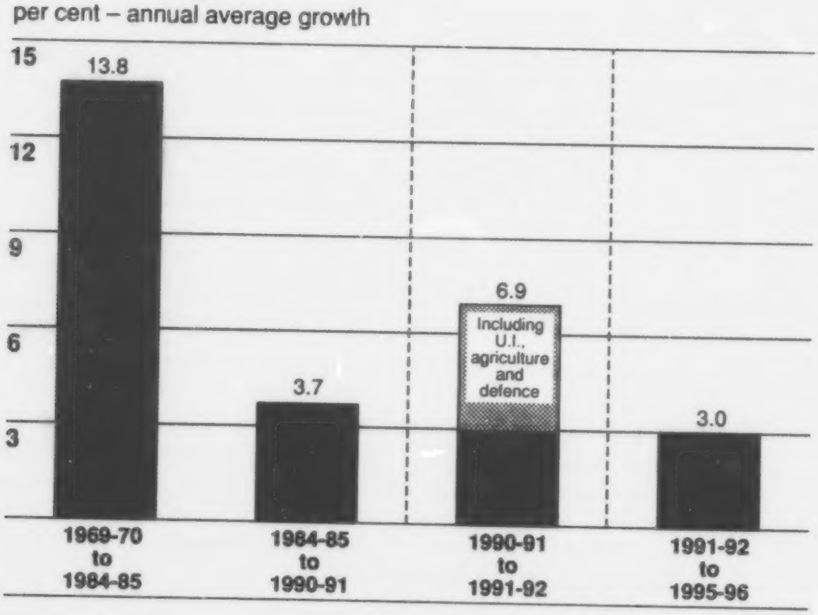
FISCAL IMPACTS OF THE BUDGET MEASURES

Table 3 presents the impact of the proposed expenditure measures in this budget on the budgetary deficit. Relative to the status quo, program spending will be reduced by a cumulative amount of $12.9 billion over the five years 1991-92 to 1995-96. Associated interest cost savings amount to $1.9 billion resulting in total fiscal savings of $14.8 billion over the five years 1991-92 to 1995-96.

In 1991-92, program spending will grow 6.9 per cent, of which 4 percentage points are accounted for by temporary increases in unemployment insurance and agriculture support payments and defence spending (see Chapter 4 for details). Thereafter, program spending will be constrained to an average annual growth rate of 3 per cent over the period of extension of the Expenditure Control Plan (see Chart 5). Table 4 shows that programs exempt from the extension of the Expenditure Control Plan will grow an average of 3.9 per cent a year over the post-1991-92 period, while all other programs will grow only 1.7 per cent a year. This

Chart 5

Growth in program spending



constrained growth will extend the record of significant declines in program spending as a ratio of GDP and, as discussed in the following chapter, is instrumental in achieving the fiscal objective of significant deficit reduction leading to a surplus in financial requirements by 1994-95.

Table 4
Program spending growth

	1991-92	1995-96	Absolute change	Annual average growth
	(millions of dollars)			(per cent)
A. Exempt from Expenditure Control Plan	70,774	82,404	11,629	3.9
B. All other programs	45,026	48,197	3,171	1.7
C. Total program spending	115,800	130,600	14,800	3.0

ANNEX
LEGISLATED SPENDING LIMITS

In this budget, the government is proposing to legislate ceilings on program expenditures for the next five years. In summary, the basic parameters of the legislation to limit program spending would likely include:

Maximum authority for program spending

- In the case of the 1991-92 fiscal year, $115,800 million;
- in the case of the 1992-93 fiscal year, $119,650 million;
- in the case of the 1993-94 fiscal year, $122,800 million;
- in the case of the 1994-95 fiscal year, $126,450 million; and
- in the case of the 1995-96 fiscal year, $130,600 million.

Flexibility for Inter-Year Reallocations

Except in a limited set of prescribed circumstances, if the total of estimates of program spending of the government for a fiscal year exceeds the maximum authority for that fiscal year, the spending excess must be deducted from the maximum authorities for the succeeding fiscal years in such proportions as the Minister of Finance shall determine.

Effect of capping cumulative program spending, 1991-92 through 1995-96

With flexibility for inter-year reallocations, the effect of the legislated program spending limits will be to cap, except under a limited set of prescribed circumstances, cumulative program spending from 1991-92 through 1995-96 at the amount projected in this budget, being $615,300 million.

Prescribed circumstances under which the spending limits would not be constraining

Only in a limited set of prescribed circumstances could the legislated spending limits be exceeded. Possible cases are:

- excess spending associated with a natural disaster;
- excess spending associated with a major external shock, such as a war; and
- spending associated with self-financing programs that by law explicitly operate to neutralize the impact of any over- or under-spending on the deficit over a reasonable period of time, when such spending varies from levels projected in this budget.

Paramountcy over other acts

The legislation would override other legislation whether enacted before or after the spending limits legislation, unless that other legislation expressly states that it has effect notwithstanding the spending limits.

Implications for budgets and Main Estimates

Consequently, any budget or Main Estimates that did not comply with the legislation could only be passed by Parliament if the spending limits legislation were specifically amended.

Report on compliance with the legislation

The Comptroller General of Canada would, after each fiscal year, be required to prepare a report respecting compliance with the Act in that fiscal year and the report would be printed as part of the Public Accounts.

Public consultations

The government will soon announce details of the process for public consultations leading to legislation next fall.

CHAPTER 4: TOWARDS FISCAL BALANCE: THE FISCAL OUTLOOK

OVERVIEW

Since 1984, the government has been following a comprehensive medium-term plan for fiscal consolidation and economic renewal. It has reduced government spending, tackled waste and inefficiency in government operations, reformed the tax system to provide a more secure tax base and less distorting revenue source, and implemented structural reforms to improve the growth potential of the Canadian economy. These actions were successful in stimulating strong growth in final domestic demand, particularly in investment, over the 1985 to 1989 period. As well, they substantially controlled the deficit, cutting it in half relative to the size of the economy.

In absolute terms, the annual deficit in the government's budgetary position fell appreciably from a peak of $38.5 billion in 1984-85 to $28.2 billion in 1987-88, a drop of over $10 billion in three years. The combination of substantial fiscal actions, supported by strength in economic activity, were responsible for this sizeable fiscal consolidation.

But the negative dynamics of inflation, high interest rates and large and growing debt have impaired deficit-reduction efforts since 1987. Compounding interest costs on the $206.5 billion stock of debt in 1984-85 added a further $120 billion to federal debt outstanding by 1989-90. Although the operating balance – the difference between program spending and revenues – moved from a deficit of $16 billion in 1984-85 to a surplus of almost $10 billion by 1989-90, this surplus was overwhelmed by rapidly rising debt interest payments. By 1989-90, the deficit remained at $29 billion despite continued tight control over spending whose growth averaged only 3.6 per cent from 1984-85.

Higher-than-expected interest rates in 1990 are exerting strong upward pressure on the deficit in 1990-91 and beyond. In 1990-91, and particularly 1991-92, the recession has further worsened the fiscal balance. The government expects real output to decline by just under 2½ per cent in the current recession. This will reduce tax revenues and increase expenditures, particularly unemployment insurance payments.

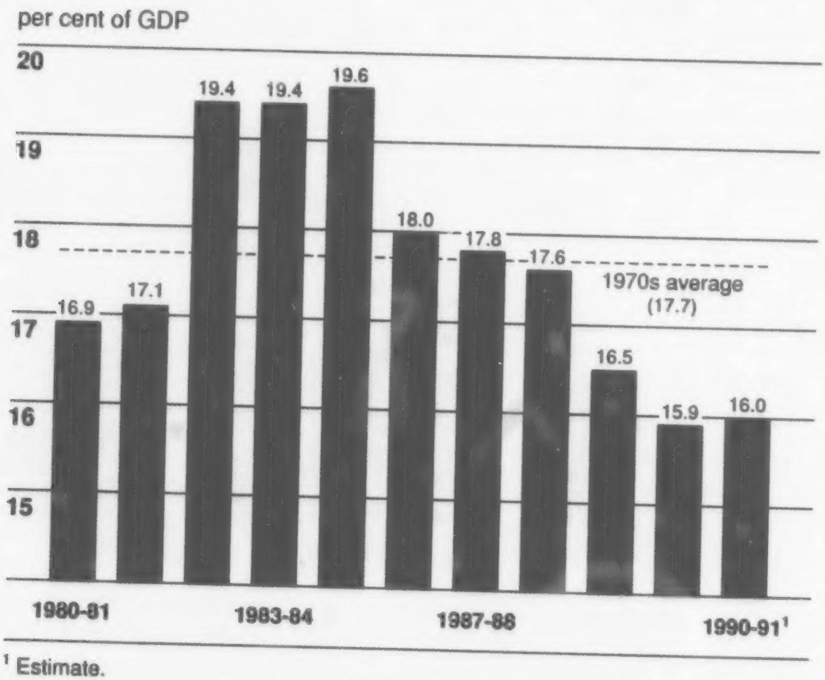
The measures introduced in this budget, coupled with the initiatives implemented in previous budgets to change the structure of spending and revenues, will hold the deficit to $30.5 billion both this fiscal year and next. The debt-to-GDP ratio will peak in 1991-92 and then decline. By 1992-93, the measures in this budget together with a decline in interest rates and the ending of the transitional costs associated with the implementation of the GST will result in a drop in the deficit to below $25 billion – the first time in over a decade. Beyond 1992-93, the fiscal outlook is still on track to reach a surplus on a financial requirements basis by 1994-95 – the first time since 1969-70.

The fiscal actions introduced in this budget are supported by legislated changes to control program spending. The government proposes to legislate ceilings on spending and to establish the Debt Servicing and Reduction Fund. Program spending over the 1991-92 to 1995-96 period will be limited by law to the planning numbers in this budget. The legislated Debt Servicing and Reduction Fund will apply GST revenues (and privatization proceeds and private remittances) to service and reduce the debt and will thereby demonstrate the government's resolve not to finance program spending from GST revenues.

THE FISCAL RECORD: 1984-85 TO 1990-91

In 1984, the fiscal situation of the government was in a critical state. The budgetary deficit had tripled to over $38 billion in just four years. Public debt was growing by almost 25 per cent per year, program spending was expanding at double digit rates, and public debt charges were consuming a rapidly increasing proportion of federal revenues. Increasing resort to debt financing meant that, by 1984-85, the average Canadian taxpayer received $1.33 in goods and services from the federal government for each $1.00 of taxes sent to Ottawa. This created false expectations of well-being for tax payers and an unstable fiscal situation for the country.

Chart 1
Program expenditures
1980-81 to 1990-91



[1] Estimate.

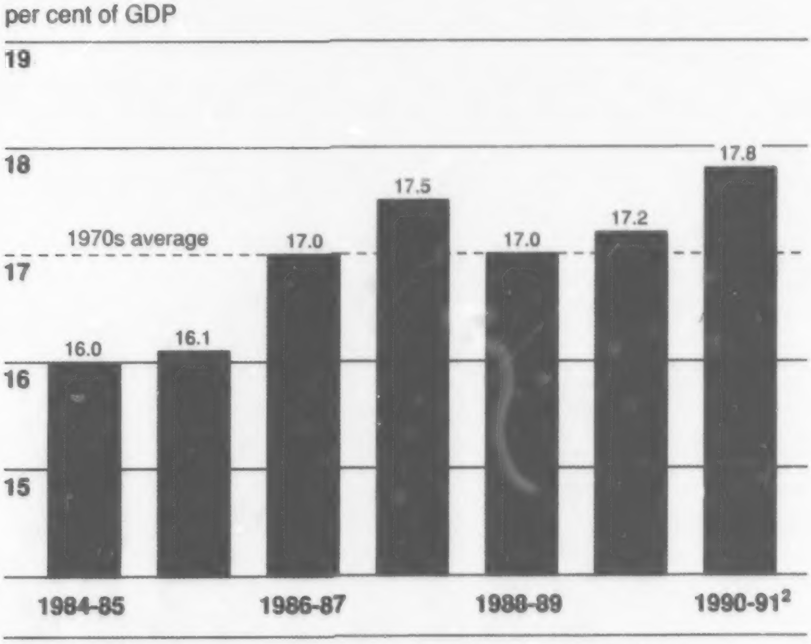
The government responded with a medium-term approach to fiscal consolidation. The *Agenda for Economic Renewal* in the fall of 1984 set out a planning framework to restore control over the fiscal situation and introduce complementary structural policies to increase Canada's economic potential. The government's strategy for debt control through deficit reduction since 1984 has had four thrusts:

- spending reductions;
- tax reform for a more secure, equitable, and balanced tax base;
- revenue increases where necessary; and
- structural reforms to improve economic growth potential.

The cornerstone of the fiscal strategy has been restraint in federal program spending. After peaking at 19.6 per cent of GDP in 1984-85, program spending declined to 16.0 per cent in 1990-91 (see Chart 1). Its growth over the last six years has been less

Chart 2

The revenue yield: budgetary revenues[1]
1984-85 to 1990-91



[1] Excludes the impact of cash management initiatives affecting the timing of remittances of personal and corporate income, sales and excise taxes.

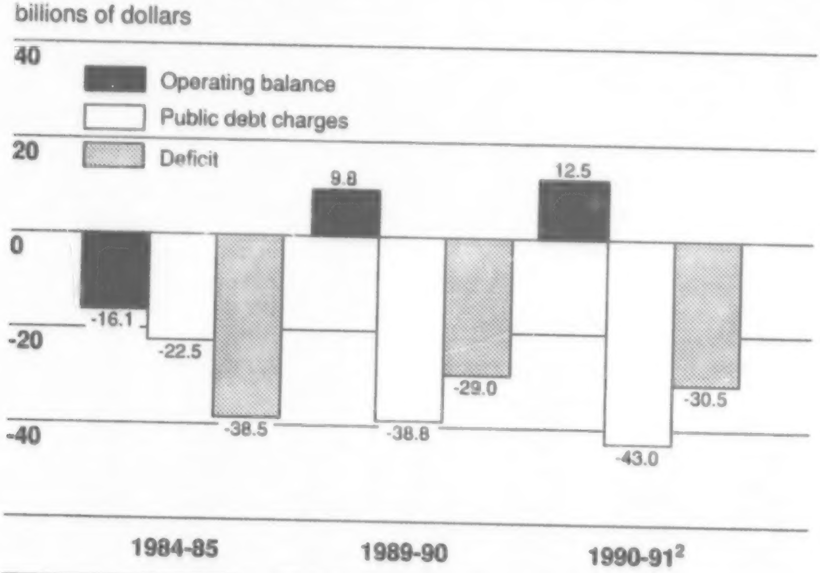
[2] Estimate.

than half the growth in the economy, averaging 3.7 per cent a year, or about 0.7 percentage points less than the rate of inflation. By comparison, growth averaged 13.8 per cent a year in the previous 15 years, or nearly 6 per cent in real terms. Chapter 3 gives details on the government's record of expenditure restraint.

The decline in the revenue yield – budgetary revenues as a proportion of GDP – in the late 1970s and early 1980s contributed considerably to increasing the deficit. It fell from a peak of 19.2 per cent in 1974-75 to 16 per cent in 1984-85. The decline reflected a proliferation of tax expenditures, tax cuts, endemic flaws in the manufacturers sales tax that led to steady erosion of the tax base, and direct effects of the 1981-1982 recession. Reflecting the measures in various budgets since 1984, the revenue yield has been gradually restored to 17.8 per cent by 1990-91, slightly above the average of the 1970s (see Chart 2).

The operating balance – the difference between program spending and revenues – has improved dramatically because of restraint in program spending and the increase in the revenue yield (see Chart 3). From a deficit in 1984-85 of $16.1 billion, the

Chart 3
The budgetary deficit, public debt charges and the operating balance[1]



[1] Operating balance is the budgetary deficit excluding public debt charges, i.e. budgetary revenues less program spending.

[2] Estimate.

operating balance swung into a surplus of $12.5 billion in 1990-91. Of this improvement, two-thirds is due to program expenditure restraint, the remaining one-third results from revenue increases (see Table 1). But rapidly rising debt servicing costs absorbed much of this improvement in the operating balance, hampering deficit reduction efforts.

This continued rapid growth of debt charges since 1985, reflects the dangerous dynamics of deficits and debt. Public debt charges, as a proportion of GDP, amounted to 5.0 per cent in 1984-85. However, with both the rise in the debt and the increase in interest rates during the latter half of 1988 and on into 1990, public debt charges today have risen to 6.3 per cent of GDP. Put differently, of the $28.5 billion improvement in the operating balance between 1984-85 and 1990-91, $20.5 billion was required simply to pay the increased interest charges on the public debt, leaving only $8 billion to reduce the deficit.

Between 1984-85 and 1987-88, the deficit declined from its peak of $38.5 billion, or 8.7 per cent of GDP, to $28.2 billion or just over 5 per cent of GDP. Deficit reduction since 1987-88, however, has been stymied by ballooning debt servicing costs. The deficit declined to 4.5 per cent in 1990-91 as a percentage of GDP (see Chart 4). However, it increased to $30.5 billion in absolute terms, largely reflecting higher-than-expected debt servicing costs and the emerging impacts of the recession.

Table 1

Key fiscal indicators: the 1984-85 to 1990-91 record

	1984-85	1990-91	Change	Relative contribution
	(per cent of GDP)			(per cent)
Operating balance				
Budgetary revenues	16.0	17.8	1.8	33
Program spending	19.6	16.0	-3.6	67
Operating surplus/ deficit (-)	-3.6	1.8	5.4	100
Budgetary deficit				
Public debt charges	5.0	6.3	1.3	
Budgetary deficit	-8.7	-4.5	3.2	

Note: Totals may not add due to rounding.

THE FISCAL CHALLENGE

The government set out an ambitious five year fiscal plan in the April 1989 budget to:

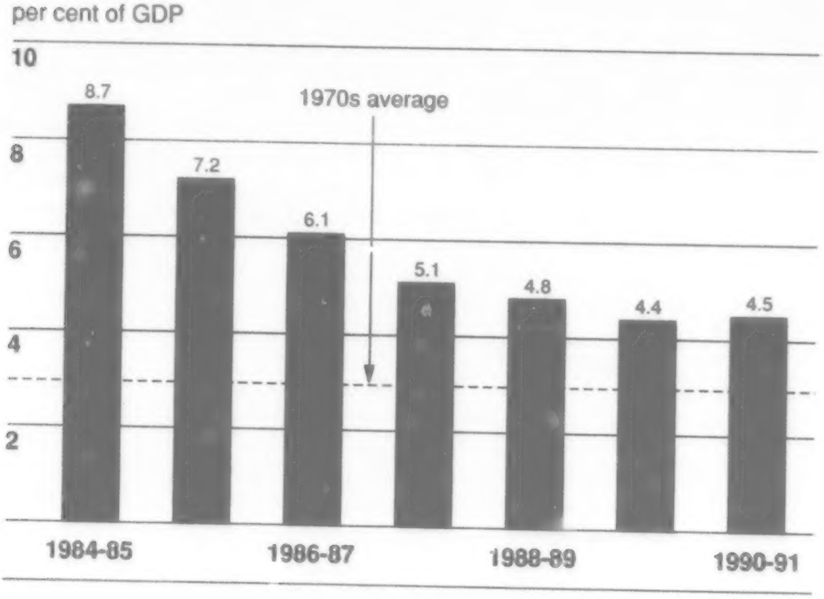
- cut the deficit in half to around $15 billion by 1993-94,
- begin to reduce outstanding debt held by the general public by 1994-95; and
- stabilize the debt-to-GDP ratio by 1991-92, with declines thereafter.

The February 1990 budget introduced the Expenditure Control Plan to assist in realizing the April 1989 budget's fiscal objectives.

Since the February 1990 budget, economic developments have put achievement of the fiscal objectives set out in both the April 1989 and February 1990 budgets at risk. Inflation pressures during the first half of 1990 turned out to be more entrenched than expected and monetary conditions had to tighten. Higher-than-expected interest rates led to increases in public debt charges. Another effect of the entrenched inflation pressures was that the recession in 1990 became deeper and more protracted than expected. Government spending has increased substantially in cyclically-sensitive components such as unemployment insurance benefits. In

Chart 4

The budgetary deficit 1984-85 to 1990-91



addition, depressed grain markets have led to large increases in agricultural support payments. The hostilities in the Gulf have increased military spending. At the same time, tax revenues have been affected due to weaker economic conditions, particularly in the area of corporate income tax collections where profit margins are at very low levels.

In short, without further fiscal actions, the deficit would approach $35 billion in 1991-92, and thus the Fiscal Plan first set out in 1989 and reaffirmed in 1990 would be at risk. The actions taken in this budget reduce the projected deficit for 1991-92 by $4.5 billion to $30.5 billion, and ensure that the crucial medium-term fiscal objectives put forward in the April 1989 budget are realized.

THE EXPENDITURE PLAN TO 1992-93

Table 2 sets out details of budgetary expenditures to 1992-93 by type of payment. The expenditure projections include the impacts of the proposed extension of the Expenditure Control Plan introduced in the February 1990 budget, along with the other expenditure reduction actions detailed in Chapter 3.

Total budgetary expenditures are projected to increase by 5.1 per cent in 1991-92 and 2.9 per cent in 1992-93. Growth in public debt charges is expected to slow appreciably over the next two fiscal years, reflecting the easing in inflationary pressures and the accompanying decline in interest rates.

Program spending is expected to increase by 6.9 per cent in 1991-92 in response to three temporary factors: a surge in unemployment insurance payments as a result of the recession, higher grain support payments due to depressed world grain markets, and increased defence spending related to the Gulf hostilities. Unemployment insurance benefit payments in 1991-92 are up 21.5 per cent due both to the increase in the number of unemployed and to higher average benefits. With the rebound in economic activity in the latter half of 1991 and the accompanying improvement in the labour market, the level of unemployment insurance payments stabilizes in 1992-93. To assist Canadian farmers, the government is introducing, for the 1991 crop year, a new agricultural income support program developed in consultation with provincial governments and the agricultural community. This program, which is made up of the Gross Revenue Insurance Program (GRIP) and the Net Income Stabilization Account (NISA), will replace grain income support currently delivered through the Western Grain Stabilization Account and Agricultural Stabilization Account program. In addition, defence spending reference levels were increased by $350 million in 1990-91 and $600 million in 1991-92 for expenditures related to the hostilities in the Gulf.

Aside from the three temporary factors pushing up program spending in 1991-92, program spending will grow by only 2.9 per cent. The impact on program spending of the Expenditure Control Plan reductions introduced in the February 1990 budget and extended in this budget hold the rate of growth of program spending in 1992-93 to 3.3 per cent.

Table 2
Budgetary expenditures

	1990-91	1991-92	1992-93
		(millions of dollars)	
A. Major transfers to persons	35,775	40,465	41,530
B. Major transfers to other levels of government [1]	23,300	23,100	23,575
C. Other major transfers	11,575	13,550	12,800
D. Payments to major Crown corporations	4,920	4,845	4,775
E. Defence	12,145	12,700	12,875
F. Official Development Assistance	2,600	2,750	2,835
G. Other government operations	17,985	18,225	19,610
H. Reserves net of lapse	–	165	1,650
I. Program spending	108,300	115,800	119,650
J. Public debt charges	42,950	43,200	43,950
K. Total budgetary expenditures	151,250	159,000	163,600
		(per cent change from previous year)	
A. Total budgetary expenditures	6.0	5.1	2.9
B. Public debt charges	10.6	0.6	1.7
C. Program spending	4.3	6.9	3.3
D. Consumer price index	4.8	5.6	3.2

[1] Certain transfers to other levels of government are made as a combination of cash and a transfer of tax points. Program spending includes only the cash transfer component as well as adjustments to program entitlements for prior years. Total entitlements, including cash and tax transfers but excluding prior-year adjustments, are as follows:

	1990-91	1991-92	1992-93
		(millions of dollars)	
Cash and tax transfers to other levels of government	36.3	36.9	38.1

Legislative changes to control spending

Many Canadians are concerned that medium-term fiscal consolidation may not be achieved because spending will not be adequately controlled. In this regard, they are particularly worried that higher revenues from the Goods and Services Tax will be used to increase program spending. As presented in Chapter 3, the government intends to legislate spending limits and to legislate the creation of the Debt Servicing and Reduction Fund to address these concerns.

Program spending over the period 1991-92 to 1995-96 will not be permitted to go above the projections in this budget – the program spending levels will be legislated. The establishment of the Debt Servicing and Reduction Fund will explicitly demonstrate the government's resolve not to finance program spending out of GST revenues. All GST revenues along with proceeds from privatization and debt reduction contributions from the public, will be put into this Fund; public debt charges will be the only expenditure allocated to this Fund.

The Summary Statement of Transactions (Table 4) reflects this change in accounting for the GST. With the establishment of the Debt Servicing and Reduction Fund, program spending exceeds non-GST revenues in 1991-92. Thereafter, however, total program spending is entirely financed from revenues other than the GST and there will be a growing surplus on this basis. In effect, all of the GST revenues will go directly to paying the interest on the public debt.

THE REVENUE OUTLOOK TO 1992-93

The projections presented in Table 3 provide an overview of the revenue outlook to 1992-93. They are based on the economic outlook set out in Chapter 2.

The key influence on the pattern of revenues over this period is the duration and intensity of the recession. The current recession is expected to last until mid-1991, and will likely reduce real output by almost 2½ per cent. This impacts directly on the tax bases, particularly corporate income tax, given the huge decline in corporate profits over the last year. The impact of the recession on the tax bases is offset by the increase in unemployment insurance premium rates and the increases in tobacco levies, as proposed in the budget. As a result, total budgetary revenue increases by 6 – 6 ½ per cent in both 1990-91 and 1991-92. Revenue growth of about 8½ per cent is expected in 1992-93.

Personal income tax revenue increases by an estimated 13.8 per cent in 1990-91. Lower personal income tax refunds, due to the transitional impact of tax reform, and continued strong growth in personal incomes are largely responsible for the strength of collections. The dampening effect of lower employment on personal incomes is expected to slow this growth considerably in 1991-92. The replacement of the sales tax credit, which was netted against personal income tax revenues, by the enhanced Goods and Services Tax Credit which is netted against GST revenues, results in higher personal income tax revenues in both 1991-92 and 1992-93.

The recession has had a pronounced effect on corporate profits. Rising unit labour costs and weakening demand have left corporate profit margins at their lowest levels since the 1981-1982 recession. Corporate profits have declined steadily since the

Table 3
Budgetary revenues

	1990-91	1991-92	1992-93
		(millions of dollars)	
Personal income tax	59,075	64,190	68,970
Corporate income tax	11,400	11,000	12,300
Unemployment insurance contributions	12,685	15,330	17,945
Sales and excise taxes/duties	24,965	11,600	12,625
Other revenues	10,805	10,030	9,500
Budgetary revenues (excluding GST revenues)	118,930	112,150	121,340
Goods and Services Tax	1,820	16,350	18,260
Budgetary revenues (including GST revenues)	120,750	128,500	139,600
		(percentage change from previous year)	
Personal income tax	13.8	8.7	7.4
Corporate income tax	-12.4	-3.5	11.8
Unemployment insurance contributions	18.1	20.9	17.1
Sales and excise taxes/duties	-11.3	-53.5	8.8
Goods and Services Tax	–	–	11.7
Other revenues	9.2	-7.2	-5.3
Budgetary revenues	6.2	6.4	8.6

third quarter of 1988 – by the first quarter of 1991 profits are expected to be about 50 per cent below their pre-recession peak. Moreover, profits are expected to remain nearly flat in 1991 before rebounding in 1992. Corporate income tax collections therefore decrease in both 1990-91 and 1991-92. However, the expected collections decline will be considerably less than the cumulative decline in profits, owing to the impact of the Large Corporations Tax and the base-broadening measures introduced as part of the 1988 Income Tax Reform.

Effective January 1, 1990, unemployment insurance premiums were raised to reflect the new financing arrangements announced in the April 1989 budget. Although the rate was fixed for three years, the deterioration in the labour market, and the resulting increase in unemployment insurance benefit payments, will result in a significant deficit in the Unemployment Insurance Account. As this account is intended to be self-financing through employee-employer premiums, the government proposes to increase the rate effective July 1, 1991 to ensure the financial integrity of the account. The changes in premium rates are detailed in the following section.

The main components in the category of federal sales and excise taxes and duties are the manufacturers' sales tax, customs import duties, motive fuel excise taxes, and excise levies on tobacco and alcohol products. The decline in this component in both 1990-91 and 1991-92 reflects the replacement of the federal manufacturers' sales tax by the Goods and Services Tax on January 1, 1991, coupled with refunding the manufacturers' sales tax paid on inventories.

This budget proposes to increase the excise levies on tobacco products by 3 cents per cigarette, or $6 per carton, along with proportional increases in the excise levies on cigars and other manufactured tobacco products. These changes will also apply to stock in inventory. These increases respond to the concerns expressed by many Canadians and associations about the need to reduce the incidence of smoking, especially among young people. The changes will take effect at midnight February 26, 1991. Details are set out in the Motion of Ways and Means to Amend the Excise Tax Act and the Excise Act and in the Supplementary Information Section. These excise levy measures are estimated to increase revenues by about $1.4 billion in 1991-92 and $1.1 billion in 1992-93.

The category "other revenues" is composed of non-resident withholding taxes, miscellaneous indirect taxes, return on investments, and other non-tax revenue. The decline over the next two years is due to the impact of the decline in interest rates on return on investments in 1991-92.

The Goods and Services Tax became effective on January 1, 1991. For both 1990-91 and 1991-92, the flow of revenues from this tax is affected by the one-time transitional costs associated with sales tax reform. These transitional costs include the prepayment of the Goods and Services Tax Credit to lower and modest income Canadians in December 1990 and the transitional grant to small business. The variation in growth rates between 1991-92 and 1992-93 in Goods and Services Tax revenues is primarily due to these one-time transitional costs.

Unemployment insurance account

Important changes to the Unemployment Insurance Program implemented in 1990 restructured the program to provide more training and fewer disincentives to work. In addition, the government announced that the full cost of the unemployment insurance program would be financed through employee-employer contributions. The premium for employees was set at $2.25 per $100 of insurable earnings for the years 1990, 1991, and 1992; for employers it was set at $3.15. This rate was chosen on the basis of the economic conditions expected at that time.

Economic and labour-market conditions have, however, deteriorated greatly. The account is projected to go sharply out of balance because of higher-than-expected benefit payments coupled with fixed premium rates. This would seriously jeopardize the financial integrity of this self-financed program and damage the federal government's fiscal position.

If premium rates were kept at current levels through 1992, as currently specified by legislation, the account would swing from a cumulative surplus position at the end of 1990, to a cumulative deficit of about $6 billion by the end of 1992. Very large premium rate increases, beginning in 1993, over a long time period would be required to pay down the debt and the accrued interest on it. In effect, this self-financing fund would suffer from the same vicious debt dynamics that plague the overall fiscal balance. A significant part of the premium revenue increases post-1992 would be going to pay interest charges rather than supporting benefits for the unemployed.

Premiums must be increased for good stewardship of the account and to minimize the impact on the federal government's deficit. Effective July 1, 1991, the premium rate for employees will be increased to $2.80 per $100 of insurable earnings. For employers, the rate will be increased to $3.92 per $100 of insurable earnings. In addition, the government will also introduce legislation authorizing the Employment and Immigration Commission to set premium rates for 1992.

Rates would be adjusted in such a manner to ensure the financial integrity of the account. As an assumption, it is assumed for the purposes of the budget fiscal projections that the rate for employees will remain at $2.80 for the next two years. The account is projected to be in balance by 1995.

Since the Unemployment Insurance Account is consolidated in budgetary transactions, the changes in the rates will reduce the deficit by $2.0 billion in 1991-92 and $2.4 billion in 1992-93. These figures take into account that unemployment insurance contributions are tax-creditable and that the government also contributes to unemployment insurance as an employer.

THE FISCAL OUTLOOK: 1990-91 TO 1995-96

The fiscal outlook to 1995-96 is summarized in Table 4. These fiscal projections are based on the economic assumptions described in Chapter 2 and incorporate the impacts of the proposed fiscal measures. The fiscal outlook indicates:

- The deficit increased from $29 billion in 1989-90 to $30.5 billion in 1990-91. The fiscal actions announced in this budget halt the upward movement in the deficit in 1991-92, leaving the deficit at $30.5 billion. With the impact of the measures in this and previous budgets, coupled with lower interest rates and economic recovery, the deficit declines to $24 billion in 1992-93, the first time since 1981-82 that the deficit will be below $25 billion. Thereafter, the deficit continues on a firm downward track, falling to $6.5 billion by 1995-96.
- As a proportion of GDP, the deficit declines from 4.5 per cent in 1990-91 to under 1 per cent by 1995-96 (see Chart 5), the lowest deficit-to-GDP ratio in over 25 years.
- Financial requirements (excluding foreign exchange transactions) – a comprehensive measure of the government's borrowing in credit markets – fall from $23.8 billion in 1990-91 to under $15 billion in 1992-93. By 1994-95,

Table 4
Summary statement of transactions: Budget 1991

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96
			(millions of dollars)			
A. Public accounts						
Budgetary transactions						
Budgetary revenues	120,750	128,500	139,600	150,500	160,300	167,500
Program spending	-108,300	-115,800	-119,650	-122,800	-126,450	-130,600
Operating balance	12,450	12,700	19,950	27,700	33,850	36,900
Public debt charges	-42,950	-43,200	-43,950	-44,300	-43,850	-43,400
Budgetary deficit	-30,500	-30,500	-24,000	-16,600	-10,000	-6,500
Non-budgetary transactions						
Loans, investments and advances	300	300	650	750	500	300
Specified purpose accounts	7,400	8,250	8,850	9,350	9,800	10,200
Other transactions	-1,000	350	700	1,200	1,200	900
Net source of funds	6,700	8,900	10,200	11,300	11,500	11,400
Financial requirements (excluding foreign exchange)	-23,800	-21,600	-13,800	-5,300	1,500	4,900
Net public debt (billions of dollars)	388.5	419.0	443.0	459.6	469.6	476.1
B. Public accounts restated for debt servicing and reduction fund						
Debt servicing and reduction fund						
GST revenues/privatization proceeds/ private remittances		16,350	18,260	19,500	20,825	22,000
Public debt charges		-43,200	-43,950	-44,300	-43,850	-43,400
Balance		-26,850	-25,690	-24,800	-23025	-21,400
Other budgetary transactions						
Budgetary revenues (excluding GST)		112,150	121,340	131,000	139,475	145,500
Program spending		-115,800	-119,650	-122,800	-126,450	-130,600
Balance		-3,650	1,690	8,200	13,025	14,900
Budgetary deficit		**-30,500**	**-24,000**	**-16,600**	**-10,000**	**-6,500**
C. Memorandum			(percentage of GDP)			
Budgetary revenues	17.8	18.3	18.7	18.9	18.9	18.5
Program spending	-16.0	-16.5	-16.1	-15.5	-14.9	-14.5
Operating balance	1.8	1.8	2.7	3.5	4.0	4.1
Public debt charges	-6.3	-6.2	-5.9	-5.6	-5.2	-4.8
Budgetary expenditures	-22.3	-22.7	-22.0	-21.0	-20.1	-19.4
Deficit	-4.5	-4.4	-3.2	-2.1	-1.2	-0.7
Financial requirements	-3.5	-3.1	-1.9	-0.7	0.2	0.5
Net public debt	57.3	59.8	59.5	57.8	55.4	53.0

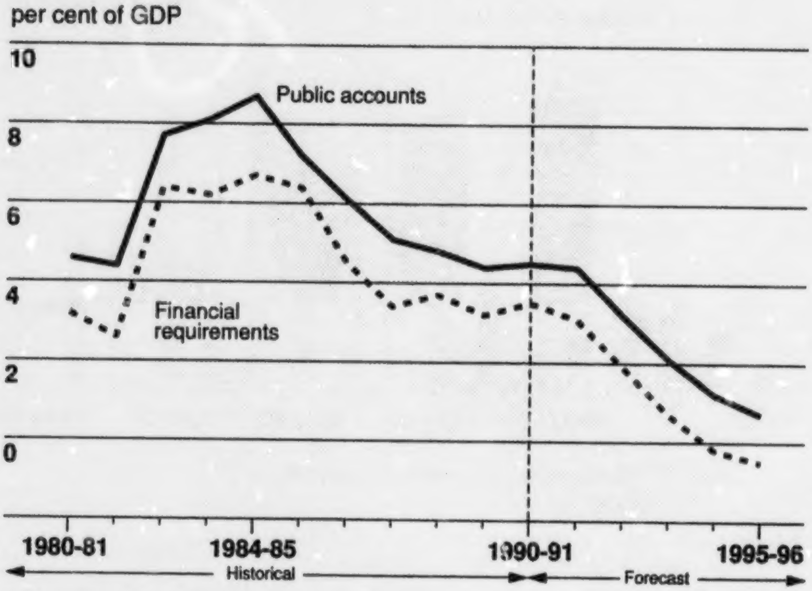
Note:

(-) indicates a net requirement for funds.

(+) indicates a source of funds.

Chart 5

The deficit and financial requirements[1]
1980-81 to 1995-96

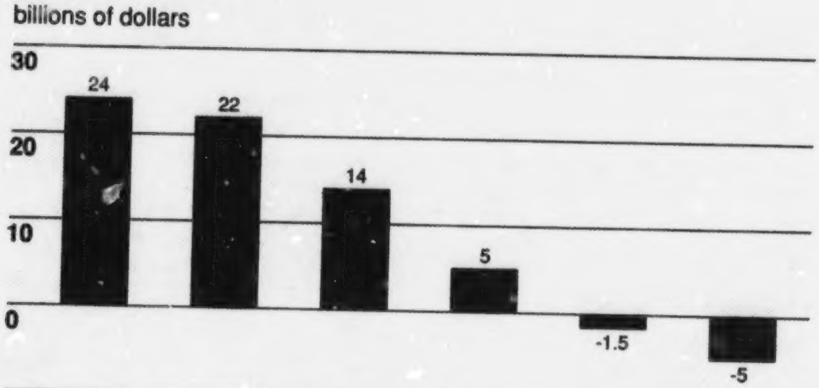


[1] Excluding foreign exchange transactions.

financial requirements will be in a surplus, the first time in 25 years, thereby achieving the fiscal objective first set out in the April 1989 budget (see Chart 6). This means that the government will begin reducing government debt held by the public in 1994-95 and beyond.

- Program spending increases by 6.9 per cent in 1991-92, due to the impact of the recession on unemployment insurance payments, of international developments on grain support payments, and the Gulf hostilities on defence spending (see Chart 7). Over the 1991-92 to 1995-96 period, the growth in program spending is constrained to average 3.0 per cent, significantly lower than the 3.7 per cent average growth rate over the 1984-85 to 1990-91 period.
- Program spending as a proportion of GDP rises slightly in 1991-92, due to factors noted above. Thereafter, it declines sharply to 14.5 per cent of GDP by 1995-96 (see Chart 8) – the lowest level in 30 years.
- The growth in public debt as a proportion of GDP is halted in 1991-92, the first time its upward trend has been arrested since 1974-75. Thereafter, it declines steadily throughout the fiscal framework period (see Chart 9).

Chart 6
Financial requirements[1]
1990-91 to 1995-96



[1] Excluding foreign exchange transactions.

Chart 7
Growth in program spending

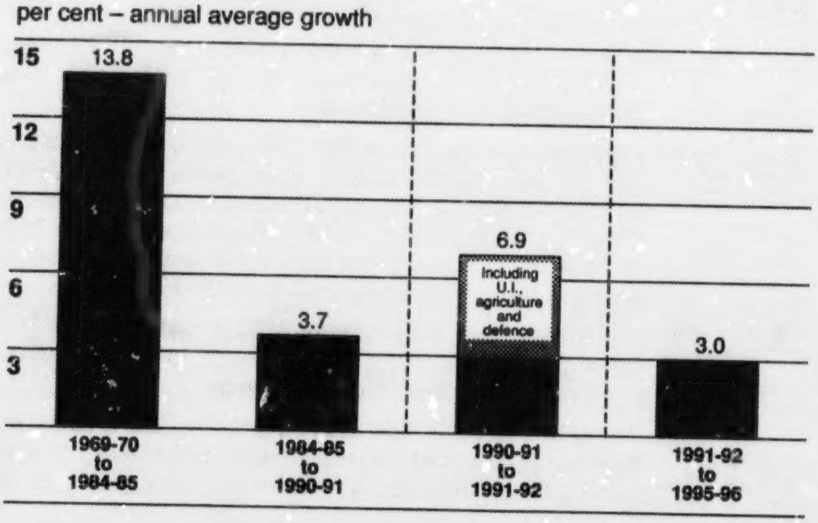


Chart 8

Program expenditures
1980-81 to 1995-96

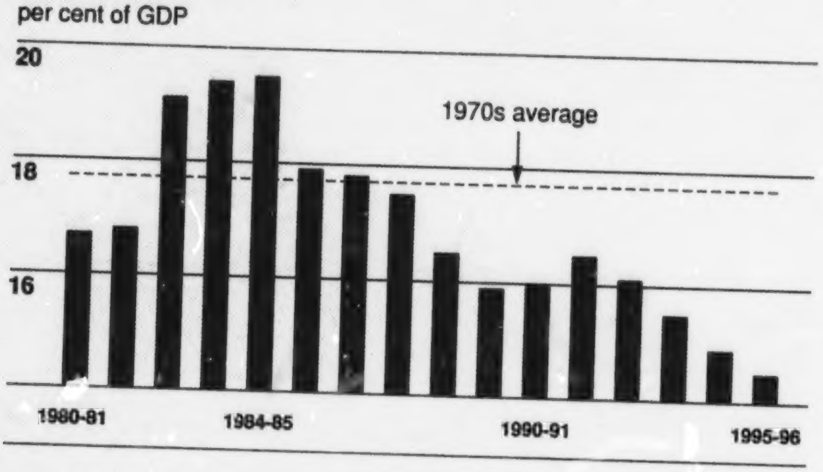
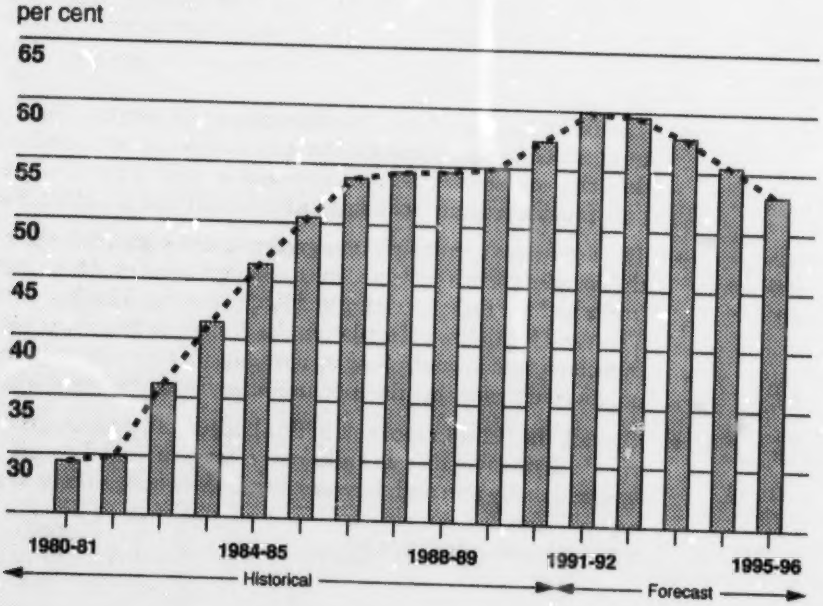


Chart 9

The debt-to-GDP ratio:
1980-81 to 1995-96



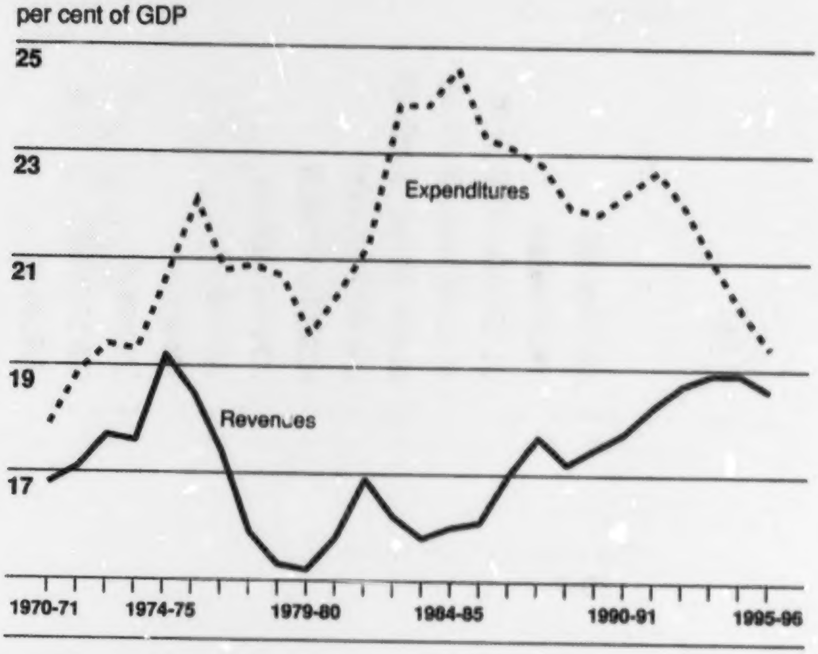


Chart 10
Budgetary revenues and budgetary expenditures 1970-71 to 1995-96

- The establishment of the Debt Servicing and Reduction Fund places revenues from the Goods and Services Tax into an account to be credited against public debt charges. Beyond 1991-92, revenues excluding the GST are sufficient to not only finance program spending, but to contribute to deficit and debt reduction.
- The legislative spending limits implemented with this budget will ensure that the spending levels projected in this budget are met. These legislated spending limits and the Debt Servicing and Reduction Fund are key structural initiatives. They will formalize in legislation the discipline that the government has applied in recent years in controlling its spending. In this way, they should enhance public confidence that the medium-term fiscal objectives will be achieved.
- Overall, the fiscal framework in this budget indicates that the unstable structure of federal finances that was allowed to develop from the early 1970s onward is fundamentally reversed. Revenue yields have been stabilized and budgetary expenditures as a proportion of GDP are finally being brought in line with these revenue yields (see Chart 10).

RECONCILIATION WITH THE FEBRUARY 1990 BUDGET

Changes to the deficit since the February 1990 budget are provided in Table 5. In 1990-91, the deficit is forecast at $30.5 billion, $2.0 billion higher than the February 1990 budget estimate. In 1991-92, the deficit is also forecast at $30.5 billion, about $3.7 billion higher than the February 1990 budget estimate.

The changed economic environment since the February 1990 budget had a number of impacts on the 1990-91 budgetary position. Personal income tax revenues were stronger than expected, reflecting the rapid growth in employment in late 1989 and early 1990 and strong growth in nominal wages throughout 1990. On the other

Table 5
Change to the deficit since the February 1990 budget

	1990-91	1991-92
	(billions of dollars)	
February 1990 budget deficit	28.5	26.8
Changes due to economic factors		
Personal income tax	-2.6	-2.2
Corporate income tax	1.0	2.6
Other revenues	0.1	0.5
Unemployment insurance benefits	0.9	3.0
Canada Assistance Plan	0.5	0.2
Agricultural assistance		0.9
Other program spending	0.3	0.9
Net impact on operating balance	0.2	5.9
Public debt charges	1.8	1.7
Changes due to policy actions		
Unemployment insurance premiums	0.0	-2.0
Indirect taxes		-1.4
Expenditure Control Plan savings	-0.4	-1.1
Spending related to the Gulf hostilities	0.4	0.6
Net impact	0.0	-3.9
Total changes	2.0	3.7
February 1991 budget deficit	30.5	30.5

Note:
(-) indicates a decrease in the deficit.
(+) indicates an increase in the deficit.

hand, corporate profits were down substantially in 1990, and this depressed corporate income tax collections by $1 billion. The rising unemployment rate in the second half of 1990 increased unemployment insurance payments by almost $1 billion relative to the February 1990 budget projection. Canada Assistance Plan transfers are up in 1990-91 due to prior-year adjustments and unavoidable delays in implementing the February 1990 budget restraint measure. The net impact of these factors was essentially offsetting. However, substantially higher-than-expected interest rates resulted in public debt charges $1.8 billion higher than forecast at the time of the February 1990 budget. Increases in defence spending relating to the Gulf War were offset by a 2-per-cent reduction in government operating and maintenance budgets in 1990-91.

For 1991-92, the full impacts of the recession on the fiscal framework are evident. Corporate income tax collections are down substantially as corporate profits continue to decline, weaker economic activity affects the other tax bases, and agriculture is up, reflecting the reform of agricultural assistance programs (Gross Revenue Insurance Program and the Net Income Stabilization Account). The deficit in 1991-92 is also negatively impacted by an additional $600 million in defence spending related to the hostilities in the Gulf War. But the key impact on program spending levels and the deficit is the $3 billion increase in unemployment insurance payments relative to the levels projected in the February 1990 budget. The impact of higher-than-expected interest rates in 1990 also carried over to fiscal year 1991-92, raising the deficit by a further $1.7 billion. Some offset is provided by stronger than expected personal income tax collections.

To partly offset these impacts on the 1991-92 deficit, this budget introduces measures to restore the financial integrity of the Unemployment Insurance Account, to reduce program spending and to increase the excise levies on tobacco products. These actions total $4.5 billion.

FACTORS AFFECTING FINANCIAL REQUIREMENTS

The government's net financial requirements consist of non-budgetary, as well as budgetary transactions. These include loans, investments and advances, government employees' pension accounts, other specified-purpose accounts, interest and debt accounts, and other non-budgetary transactions. Total non-budgetary transactions have normally provided the government with a net source of funds, lessening its dependence on financial markets. Table 6 sets out the projection for non-budgetary transactions to 1992-93.

The principle underlying the distinction between budgetary and non-budgetary transactions is that transactions changing the net indebtedness of the government are classified as budgetary, and those involving the receipt of offsetting financial assets or the creation of liabilities are classified as non-budgetary. In addition, the government maintains a number of trust accounts that are held for third parties, such as pension accounts of federal government employees. Other non-budgetary transactions include accounting adjustments to certain budgetary transactions that are recorded on an accrual basis to a cash basis. These include interest accounts, accounts payable, cash-in-transit, and outstanding cheques.

Table 6
Non-budgetary transactions

	1990-91	1991-92	1992-93
		(billions of dollars)	
Loans, investments, and advances	0.3	0.3	0.7
Specified purpose accounts	7.4	8.3	8.8
Other transactions	-1.0	0.4	0.7
Non-budgetary transactions	6.7	8.9	10.2

Note: Figures may not add due to rounding.

FINANCIAL REQUIREMENTS AND BORROWING AUTHORITY

The amount of borrowing authority requested from Parliament for a fiscal year has traditionally been tied to the financial requirements forecast for that year. The actual level of borrowing is also influenced by foreign exchange transactions that cannot be forecast in advance.

For 1991-92, the government will be seeking borrowing authority in the amount of $26.4 billion, to cover financial requirements of $21.6 billion, expected Exchange Fund earnings of $1.8 billion, and a $3 billion contingency to manage foreign exchange transactions (Table 7). Borrowing authority to cover Exchange Fund earnings is requested because these earnings, although reported as budgetary revenues, remain in the Exchange Fund Account and are not available to finance ongoing operations of government.

Table 7
Borrowing requirements

	1991-92
	(billions of dollars)
Financial requirements (excluding foreign exchange requirements)	21.6
Exchange fund earnings	1.8
Reserve for contingencies	3.0
Total borrowing authority requested	26.4

ANNEX
DEFICIT COMPARISONS ACROSS COUNTRIES: INTERNATIONAL ACCOUNTING CONVENTIONS

The purpose of the Government of Canada's public accounts is to record revenues, expenditures, assets and liabilities in order to permit parliamentary control of public funds. The difference between annual budgetary revenues and expenditures is the budgetary deficit or surplus for the year, and the cumulation of the annual deficits (and surpluses) is the net public debt.

Another frequently used indicator of the government's financial situation is financial requirements (excluding foreign exchange transactions). Financial requirements correspond to the public accounts deficit plus financial transactions such as loans and advances, specified purpose accounts and certain other financial transactions. Financial requirements measure the amount of money the government must borrow from capital markets each year, over and above that required to refinance existing debt in order to pay its bills.

A third measure of the government's financial position is provided by the Canadian Income and Expenditure Accounts. These quarterly national accounts, whose primary aim is to provide the broadest possible measure of economic activity in the Canadian economy, measure public sector transactions in a way consistent with transactions in other sectors of the economy. Since both financial requirements and the national accounts deficit include non-budgetary transactions such as the government superannuation accounts (which are excluded from the public accounts deficit as a source of funds), they tend to be quite similar.

There is no international accounting convention for the statement of a government's financial position or net debt; indeed, every country tends to have its own national system of financial accounts. The public accounts of the Government of Canada follow generally accepted accounting procedures. In particular, they exclude revenues from trusteed accounts as a source of funds unlike either the financial requirements or the national accounts deficit. Thus, financial requirements and the national accounts deficit are lower than the public accounts deficit.

Some examples will put these differences in accounting conventions in perspective. In 1990-91, the public accounts deficit in Canada is $30.5 billion, or 4.5 per cent of GDP. Financial requirements are $23.8 billion, or 3.5 per cent of GDP (and the national accounts deficit, as noted above, is similar to financial requirements). The "unified budget deficit" in the United States, the accounting basis for the financial position of the U.S. government, is very similar to Canadian financial requirements. In the U.S. 1991 fiscal year, their unified budget deficit as a proportion of GNP will be 5.7 per cent, compared to 3.5 per cent in Canada.

CHAPTER 5: INFLATION TARGETS: ESTABLISHING THE PATH TO PRICE STABILITY

OVERVIEW: AN ECONOMIC ENVIRONMENT FOR GROWTH

A series of inflation targets to achieve price stability is a key element in the plan for economic renewal set out in this budget. The government, together with the Bank of Canada, has set the targets to reduce inflation from a rate of more than 5 per cent now to 2 per cent by the end of 1995. The 1991 federal budget and a communiqué from the Bank of Canada launch this initiative and explain why and how price stability must be attained.

Since 1984, the government has concentrated economic policy on putting the country back on the path of strong, sustainable growth to raise Canadian living standards. Structural reforms encouraged investment, increased productivity, and bolstered the growth potential of the economy. Macroeconomic policy fostered the fiscal stability and supportive environment essential for the economy to realize its potential. The present budget continues this thrust with further measures to reduce the deficit and government demands on scarce resources.

Setting inflation on a downward track to price stability is also needed to create the right macroeconomic environment. In the 1950s and 1960s – when we had such an environment – not only was the fiscal position in balance, but inflation was low, growth was robust and living standards rose rapidly. Similarly, in the late 1980s, countries like Germany and Japan that kept their inflation rates low generally enjoyed the healthiest growth.

In Canada, however, inflation was allowed to rise in the 1970s and 1980s, its pernicious effects exacting the inevitable costs. Inflation saps productivity and distorts economic decisions. It takes income away from those unable to protect themselves, such as the elderly and people on fixed incomes. It raises interest rates because lenders demand a premium to compensate for the erosion of real values as prices rise; the cost of capital increases, not only for this reason but also because of a premium for the uncertainty caused by high inflation. By raising interest rates, inflation also plays havoc with the government's fiscal position.

Low inflation is one reason the cost of capital is lower in Japan and Germany than in Canada and the United States. Canada's higher capital costs damage international competitiveness and lower the potential output of our economy. Achieving price stability is therefore one of the most effective ways of enhancing Canada's competitiveness abroad and prosperity at home.

Failure to quell inflation in recent years has been at the root of wasteful cycles of boom and bust. In the 1970s, inflation was allowed to ratchet-up, rising until checked or temporarily lowered by an inevitable downturn, then resuming its climb from the higher base. Expectations of higher inflation took firmer hold with each turn of the ratchet.

Ratcheting-up continued until 1981 when the most serious recession in Canada's postwar history brought inflation down from a peak of almost 13 per cent to 4 to 5 per cent. The severity of the recession was due to the strength of inflation expectations. Similarly, difficulty in containing inflation pressures that built up over the latter part of the 1983-1989 expansion helped cause the present downturn. The current recession shows clearly the inevitable results of an acceleration of inflation; it emphasizes the need to keep inflation pressures under control and further lower both inflation and inflation expectations.

In recent years, the government and the Bank of Canada have made a clear commitment to achieving price stability in order to promote stable growth, equity, and prosperity in Canada. Now the government and the Bank are setting the timetable for achieving price stability to encourage a more rapid adjustment of expectations to a lower inflation environment.

The inflation targets are the key steps on the path to price stability. They should give Canadian consumers, business people, labour, and investors a better understanding of how quickly price stability can and will be achieved. This should reduce the resistance to lower inflation, thus bringing about its benefits more quickly and more easily.

The first target is to lower the annual increase in the consumer price index (CPI) to 3 per cent by the end of 1992. An interim milepost of 5 per cent – less than 4 per cent excluding the impact of the Goods and Services Tax (GST) – has been set for the end of 1991. Inflation should decline to 2½ per cent by mid-1994 and to 2 per cent by the end of 1995.

Beyond 1995, economic policy will be formulated to conform with the objective of price stability, defined as inflation clearly less than 2 per cent. Further experience, analysis and consultations will be needed to arrive at a more precise definition of price stability and the path to it in the period after 1995.

THE BENEFITS OF ACHIEVING PRICE STABILITY

The costs of inflation are pervasive and insidious.[1] As the Governor of the Bank of Canada said in October:

> We have a market economy, and one of its pillars is the institution of money and monetary exchange... The prices of goods and services are set in money terms. We keep economic score and frame our day-to-day and longer-term decisions in money terms. Damaging that institution,

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[1] More detailed discussions of the costs of inflation can be found in Selody, Jack, "The Goal of Price Stability: A Review of the Issues", Bank of Canada Technical Report No. 54, May 1990; Howitt, Peter, "Zero Inflation as a Long-Term Target for Monetary Policy", in R.G. Lipsey, ed., Zero Inflation: The Goal of Price Stability, C.D. Howe Institute Policy Study No. 8, March 1990; or Fischer, Stanley, Indexing, Inflation and Economic Policy, (Cambridge, Mass., The MIT Press, 1986).

> as inflation must, introduces needless uncertainty and thereby makes our economy less efficient and less productive. It also injects inequity, hurting some groups of people to the benefit of others, and for no socially worthwhile purpose.[2]

A money whose value is preserved will eliminate the social inequity of inflation-induced redistributions of income. Price stability will bring substantially lower interest rates. If the economy is to function at its full potential, the public must have confidence in its money; only a money that holds its value will inspire that confidence. Public expectation that the value of money will be preserved will enable the economy to adjust much more smoothly to price and demand shocks.

Greater social equity

The most obvious cost of inflation is its effect on the value of money. Inflation erodes the real value of money and savings, taking purchasing power away from people living on fixed incomes or depending on savings. At an inflation rate of 5 per cent, for example, the purchasing power of a fixed nominal stream of income – such as an unindexed pension – is halved in 14 years.

The problems associated with losses of purchasing power are worse when inflation is variable and unpredictable. The redistribution of income and wealth in such a climate creates "winners" and "losers". Those with the means and knowledge to take advantage of profitable opportunities created by inflation, or the ability to pay for sophisticated financial advice, often benefit at the expense of poorer or less financially sophisticated members of society. Inflation may therefore increase inequality in income and wealth and create strains on the social fabric of a nation.

Lower interest rates

High inflation results in high interest rates. Lenders expecting high inflation will demand a high interest rate to compensate for the loss in purchasing power of the money loaned. Borrowers will be willing to pay the higher interest rate because the real value of the loan will be less later.

The only way to bring interest rates down permanently is to reduce inflation and inflation expectations permanently. An attempt to bring interest rates down in the face of serious inflation pressures would be self-defeating. Short-term rates might come down initially, but this would stimulate demand and aggravate inflation pressures. Expectations of higher inflation would increase, causing long-term interest rates to rise almost immediately. As the inflation rate increased, short-term interest rates would increase as well. Lower inflation, rather than overly expansionary monetary policy, is the route to lower interest rates.

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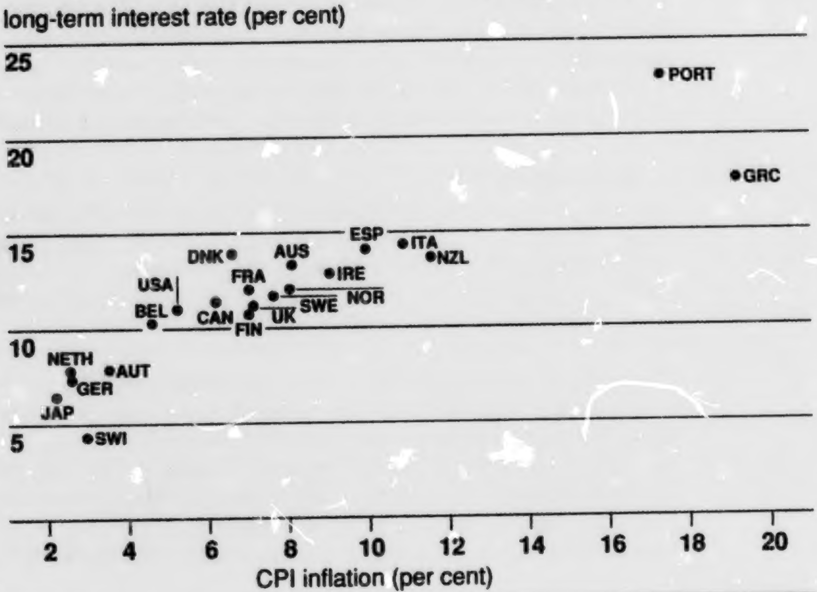
[2] See "Remarks by John W. Crow, Governor of the Bank of Canada, to the Greater Moncton Chamber of Commerce, Moncton, New Brunswick, 24 October, 1990", reproduced in Bank of Canada Review, November 1990, pp. 3-4.

Chart 1
CPI inflation versus long-term interest rate: OECD countries 1980-1989 average

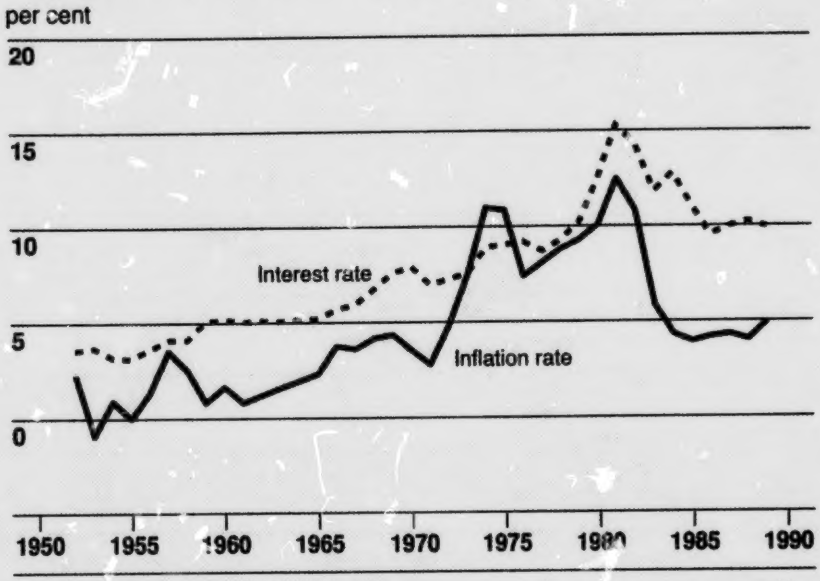


AUS	Austria	GER	Germany	NOR	Norway
AUT	Australia	GRC	Greece	PORT	Portugal
BEL	Belgium	IRE	Ireland	ESP	Spain
CAN	Canada	ITA	Italy	SWE	Sweden
DNK	Denmark	JAP	Japan	SWI	Switzerland
FIN	Finland	NETH	Netherlands	UK	United Kingdom
FRA	France	NZL	New Zealand	USA	United States

A wealth of international and Canadian experience attests to this truth. Chart 1 clearly shows that countries with lower inflation rates have lower interest rates. Chart 2 makes the same point with Canadian data. When Canadian inflation rates were low in the 1950s and 1960s, Canadian interest rates were also low. When inflation rates rose in the 1970s and 1980s, by contrast, interest rates also rose. In getting inflation down, therefore, the government is in fact paving the way for lower interest rates.

As many Canadians who own their own homes – or hope to – have discovered, an increase in nominal interest rates can have significant effects on household disposable incomes. Many nominal debt contracts, such as mortgages, require a constant nominal amount to be paid each month. When there is inflation and nominal interest rates are high, a constant stream of monthly payments means that

Chart 2
Canadian inflation versus
Canadian long-term government bond yield



the *real* value of the payments is high at the beginning of the contract but declines over time, a phenomenon called "front loading" a debt.[3] In other words, the borrower must devote a larger share of disposable income to paying down the real value of the debt in the early years of the contract. This can make housing difficult to afford, particularly for first-time buyers.

High nominal interest rates also raise the cost of servicing the public debt. This means that a higher share of every tax dollar must go to paying interest, leaving less money to fund government programs. Either programs must be cut or taxes must be raised. With a net public debt of about $388 billion at the end of the 1990-91 fiscal year, each percentage point increase in interest rates raises debt servicing costs by almost $2 billion after one year and by about $4 billion after four years. To put this in perspective, $4 billion, for example, would represent an increase of 7 per cent in federal personal income taxes.

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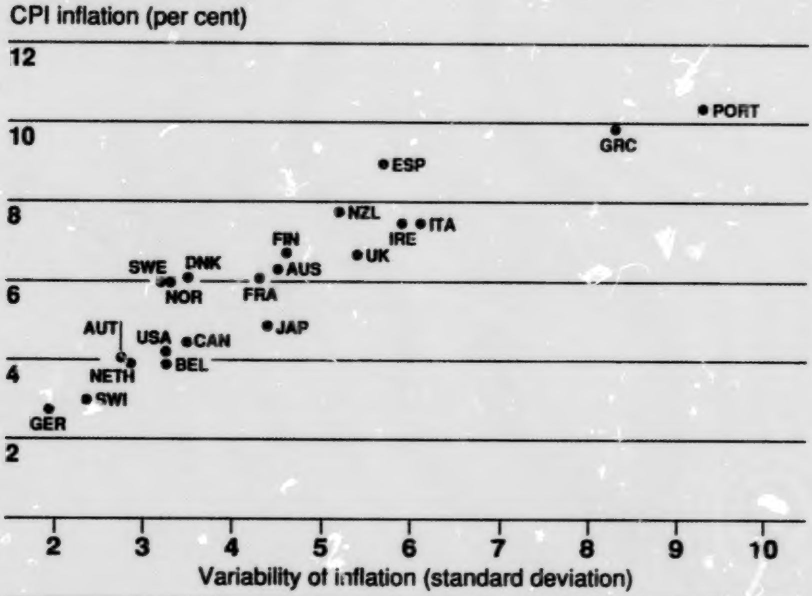
[3] For a fuller exposition of this phenomenon, see Blomqvist, Åke, Paul Wonnacott and Ronald Wonnacott. An Introduction to Macroeconomics, (Toronto, McGraw-Hill Ryerson, 1983), pp. 328-31. Take the example of a $100,000 mortgage with an amortization period of 30 years and a real interest rate of 4 per cent. With a zero rate of inflation, the monthly payments would be $477. With a 14 per cent inflation rate, the nominal mortgage rate would rise to 18 per cent (the same 4 per cent real rate plus 14 per cent for inflation), in which case the monthly payment would rise to $1,507 per month.

Chart 3

CPI inflation versus variability of inflation: OECD countries 1952-1989 average



AUS	Austria	GER	Germany	NOR	Norway
AUT	Australia	GRC	Greece	PORT	Portugal
BEL	Belgium	IRE	Ireland	ESP	Spain
CAN	Canada	ITA	Italy	SWE	Sweden
DNK	Denmark	JAP	Japan	SWI	Switzerland
FIN	Finland	NETH	Netherlands	UK	United Kingdom
FRA	France	NZL	New Zealand	USA	United States

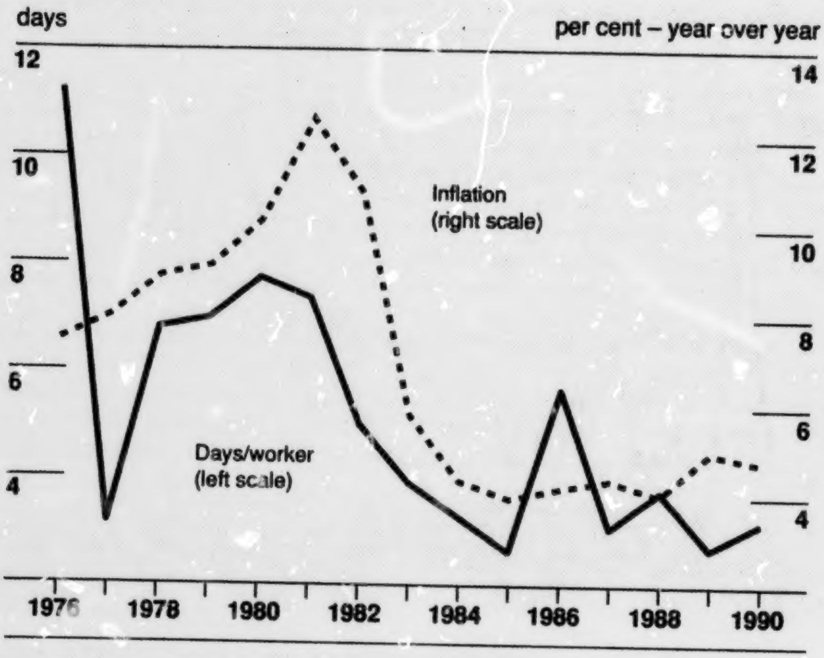
Enhanced productivity growth

Chart 3 shows the relationship between the average inflation rate and the variability of inflation rates in industrial countries from 1952 to 1989. The chart clearly shows that high inflation rates tend to be more variable than low rates. High rates of inflation are therefore likely to be accompanied by greater uncertainty about future inflation. Inflation uncertainty is especially damaging to productivity and the long-term health of the economy.

In times of uncertain inflation, planning horizons are likely to be shortened because people and companies are increasingly reluctant to enter into long-term contracts or issue long-term financial instruments. Investment is seen as riskier. In the uncertain inflation climate of the 1970s, for example, the average term of contracts for financial instruments, such as loans and security issues, declined sharply. As a result, long-term funds were no longer as readily available to finance investment.

Chart 4

Inflation and annual strike days per worker in Canada, 1976-1989



Alternatively, lenders may demand a premium to compensate for increased risk, causing interest rates to rise even higher. Higher interest rates and greater uncertainty cause the real cost of capital to rise. Research at the Federal Reserve Bank of New York and the Department of Finance suggests, for example, that lower inflation is one reason the cost of capital is lower in Japan and Germany than in Canada or the United States.[4] A higher cost of capital damages Canada's international competitiveness and lowers the potential output of the economy.

The difficulty of negotiating contracts in times of high and variable inflation is nowhere more apparent than in the labour market. Employers and employees often have quite different expectations about inflation. As well, the price of a company's output, which determines its ability to grant pay increases, may rise at a very

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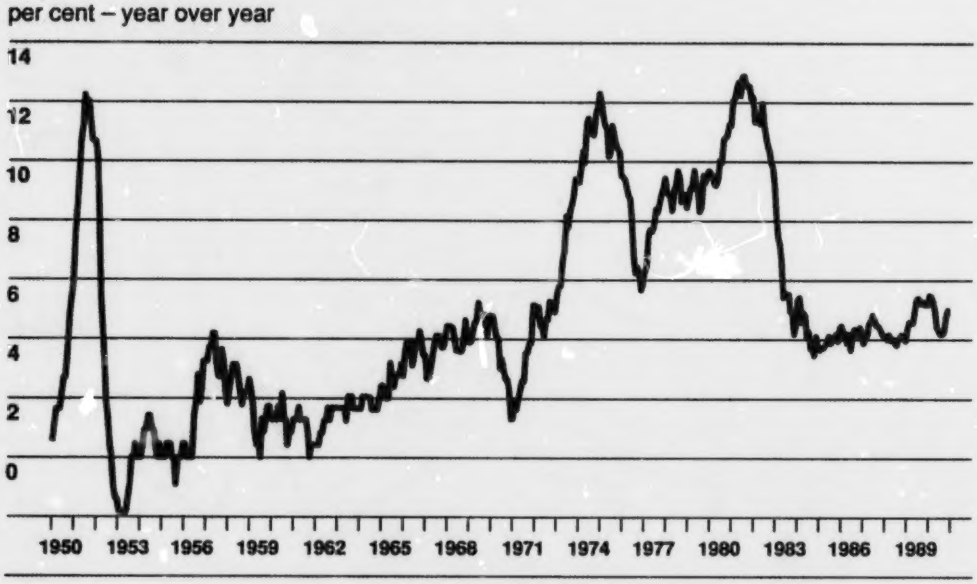
[4] See McCauley, R.N., and S.A. Zimmer, "Explaining International Differences in the Cost of Capital: The United States and United Kingdom versus Japan and Germany", Federal Reserve Bank of New York, Research Paper No. 8913, August 1989, and James, Steven, "How High is the Real Cost of Funds for Business Investment?", Quarterly Economic Review, Department of Finance (forthcoming).

Chart 5
CPI inflation in Canada
1950 to 1990



different rate from consumer prices, which form the basis of workers' wage demands. Not surprisingly, Chart 4 shows that higher inflation in Canada has been accompanied by an increase in days of work lost through strikes.

With high inflation, businesses and individuals tend to devote more time and effort to protecting themselves against inflation – or attempting to profit from it. This increased time and energy devoted to "paper transactions" diverts resources from productive uses.

Sustainable growth

Delay, or lack of resolve, in keeping inflation under control only adds to its eventual cost. In the past in Canada, governments have sometimes shown too little resolve in reacting to inflation pressures and have allowed the inflation rate to drift upward. The failure to eradicate inflation has been a fundamental cause of wasteful cycles of boom and bust in the Canadian economy since the early 1970s.

Chart 5 shows the Canadian inflation rate since the early 1950s. The clear distinction between periods of low and high inflation is noteworthy:

- After the surge caused by the Korean war, Canadian inflation settled down to rates under 2 per cent. From 1953 to 1960, the average annual inflation rate was 1.2 per cent and exceeded 2 per cent in only two years. Inflation averaged under 3 per cent over the entire 1950-1973 period.
- Inflation gathered momentum in the 1970s, and was greatly accelerated by the shocks from world oil prices in 1973 and 1979.

The policy response to inflation was frequently stop-and-go. When inflation was deemed to have accelerated excessively, the government and the Bank of Canada would implement restrictive policies that would result in a recession or sharp slowing in economic activity and partly reverse the climb in inflation. The authorities would relent, however, before inflation had been brought firmly under control and price stability restored. A pattern of ratcheting-up inflation thus emerged. With each turn of the ratchet, expectations of higher inflation took firmer hold in the public's mind.

This pattern continued up to 1981, when the most severe recession in Canada's postwar history slowed inflation from almost 13 per cent to 4 to 5 per cent. The severity of that recession was directly related to the fact that, after many years of generally rising inflation, expectations of continuing high inflation were solidly embedded.

From 1983 to 1989, the Canadian economy expanded strongly, growing at an average annual rate of 4.1 per cent, considerably faster than the growth of its productive potential. Above-potential growth was possible and indeed desirable for a time, since it put back to work unemployed productive resources left from the 1981-1982 recession.

Eventually, however, this rapid pace of growth revived inflation pressures. Growth in unit labour costs increased steadily from under 3 per cent in 1985 to almost 6 per cent in 1989 and 6½ per cent by mid-1990. The inflation rate increased to 5 per cent in 1989, and would have risen significantly higher had not an appreciation of the Canadian dollar held down the price of imports.

The government and the Bank of Canada responded forcefully to contain these inflation pressures. Letting inflation resume an upward drift, as in the 1970s, would only have started ratcheting-up inflation expectations again and ended in even higher interest rates and a more serious recession further down the road.

Achieving price stability, and the expectation that it will be maintained, should allow Canada to minimize the destructive and wasteful stop-and-go policies of the past. Although a shock may raise the inflation rate, firm expectations that price stability will be maintained over time will help the economy return to price stability without major losses in output and employment. This has been the experience of Japan and Germany in recent years, where significant demand pressures have been slower to translate into major inflation pressures; largely because of the countries' tough anti-inflation reputations, businesses, consumers, labour, and investors are confident that inflation will not be allowed to get out of hand.

INFLATION TARGETS WILL BRING FORWARD THE BENEFITS OF PRICE STABILITY

The strategy of the government and the Bank of Canada is to move in a measured and consistent way to price stability. As the Governor of the Bank of Canada stated in September:

> The Bank has never suggested that we should aim to reach price stability virtually immediately, without any regard for the short-run consequences. What we are seeking are gradual but progressive reductions in inflation that will ensure there is no doubt about the commitment of monetary policy to contribute price stability to Canada's economic well-being.[5]

Although the government and the Bank of Canada have stated their commitment to price stability, inflation expectations remain high. To substantially lower inflation expectations, the public needs to know what price stability means and when it is to be achieved. In the absence of an explicit timetable, inflation expectations may only adjust as market pressures bring inflation down. The economy would have to suffer an unnecessarily extended period of weakness to achieve price stability.

In order to encourage a more rapid adjustment of expectations to a lower inflation environment, the government and the Bank of Canada are jointly announcing a timetable for reaching price stability. Lower inflation expectations will promote a period of low interest rates and stable growth. As the economy strengthens during the coming expansion, lower inflation expectations will help avoid a vicious circle of increasing cost pressures, rising interest rates and economic weakness.

THE INFLATION TARGETS

The inflation targets are expressed as reduced rates of increase in the CPI, the most commonly used and best understood measure of inflation. Since it takes up to two years for monetary and fiscal policy to affect inflation, the first official target will be for the end of 1992. Policy will be geared toward lowering the year-over-year increase in the CPI to 3 per cent by the end of 1992.

To see whether it is on-track to achieve this goal for the end of 1992, an interim milepost of approximately 5 per cent – less than 4 per cent excluding the impact of the GST – will be set for the end of 1991.

The target rate of inflation will be steadily reduced, to 2½ per cent by the middle of 1994 and to 2 per cent by the end of 1995. Beyond this date, policy will be conducted to conform with the objective of price stability, which is being defined at this time as inflation clearly less than 2 per cent. Further experience, analysis and

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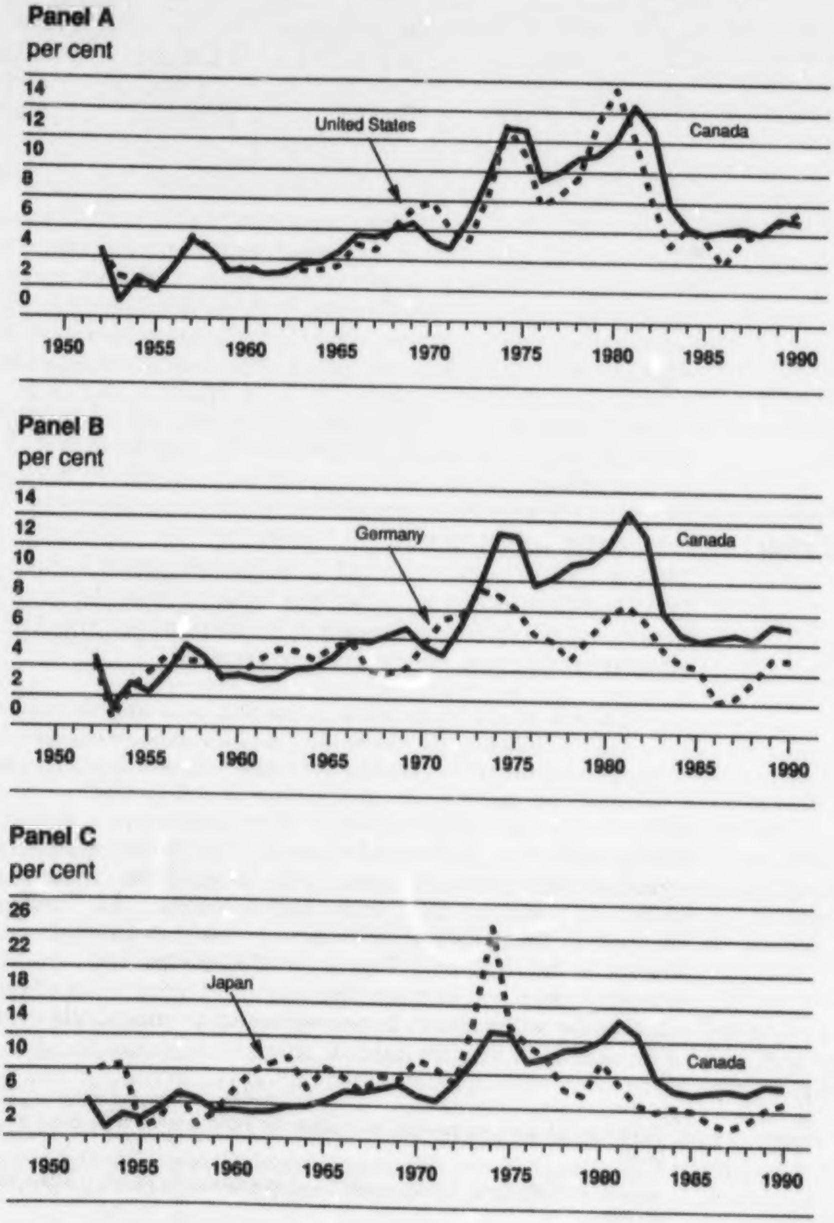
[5] "Current Monetary Policy: Notes for Remarks by John W. Crow, Governor of the Bank of Canada, to the Ottawa-Hull Chapter of the Institute of Chartered Life Underwriters of Canada, Ottawa, Ontario, 13 September 1990", reprinted in Bank of Canada Review, September 1990, p. 34.

Chart 6

CPI inflation: 1952 to 1990

Canada versus the United States, Germany and Japan



consultations on the precise definition of price stability and the path to it in the period after 1995 will be needed. This analysis will take into account statistical biases in the CPI as a measure of the cost of living and the experience gained in bringing inflation down to 2 per cent.

While monetary and fiscal policies strongly influence inflation, they act through indirect channels; this causes the intensity and the timing of their impact to vary. Further, there is considerable volatility in the food and energy components of the CPI. Consequently, for operational purposes, the monetary authorities will monitor the CPI excluding food and energy. As well, the targets will have a band of 1 percentage point on either side.[6] Effectively, the targets will accommodate the direct impacts on the CPI of short-run movements in food and energy prices but will not validate ongoing effects.

These inflation targets are necessary and realistic. Canada has achieved much lower rates of inflation in the past and can do so again. As Chart 6 shows, Canada's inflation for most of the postwar period has compared favourably with rates in other major industrialized countries, including Germany (panel b), the industrial country with perhaps the most solid low-inflation reputation. Until the late 1970s, our inflation performance was better than Japan's (panel c). Only since the 1970s has Canada's inflation performance deteriorated in comparison with that of Japan and Germany. Unlike Canada, in the 1980s, these countries succeeded in returning to or bettering the inflation performance each had known in the 1950s and early 1960s.

ACTING WITH DETERMINATION

The government and the Bank of Canada are determined to eliminate inflation. Inflation creates inequities in Canadian society and prevents the Canadian economy from realizing its productive potential. As the renowned British economist, John Maynard Keynes, observed over 70 years ago:

> There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.[7]

Canada has in the past been able to achieve and maintain rates of inflation consistent with the targets given in this chapter. Other industrial countries such as Germany and Japan in the 1980s have demonstrated that price stability can be regained. The long-term benefits of eradicating inflation are substantial and irrefutable. Interest rates will come down. Canadian productivity and competitiveness will increase. The standard of living of Canadians will rise and social equity will improve. By easing the path to price stability, inflation targets will allow these benefits to be realized sooner.

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[6] Temporary adjustments may also be made to the inflation target in the event of large changes in indirect taxes.

[7] Keynes, John Maynard, The Economic Consequences of the Peace, (London, Macmillan & Co., 1920), pp. 220-1.

CHAPTER 6: ECONOMIC POLICY IN THE FIRST HALF OF THE 1990S

INTRODUCTION

Canadians are increasingly worried about the outlook for their living standards, and their children's, through the 1990s and beyond. The challenge for governments in the first half of this decade is to put the economy onto a path of sustainable, strong expansion. If Canadians are to benefit once again from the impressive increases in living standards that they enjoyed from 1950 to the mid-1970s, changes are needed. The imbalances and pressures that currently plague the economy have to go. Government deficits and debt levels are too large. Inflationary psychology is too entrenched. Monetary conditions – interest rates and the exchange rate – are still too tight.

This budget tackles these problems by exerting firm control over expenditures, thereby providing for deficit reduction and a lowering of the public debt as a percentage of GDP. It sets the economy firmly on the course to price stability, providing for large and durable declines in interest rates. These actions will set the stage for the recovery to evolve into a strong, durable expansion. This is the essence of the government's Plan for Economic Recovery.

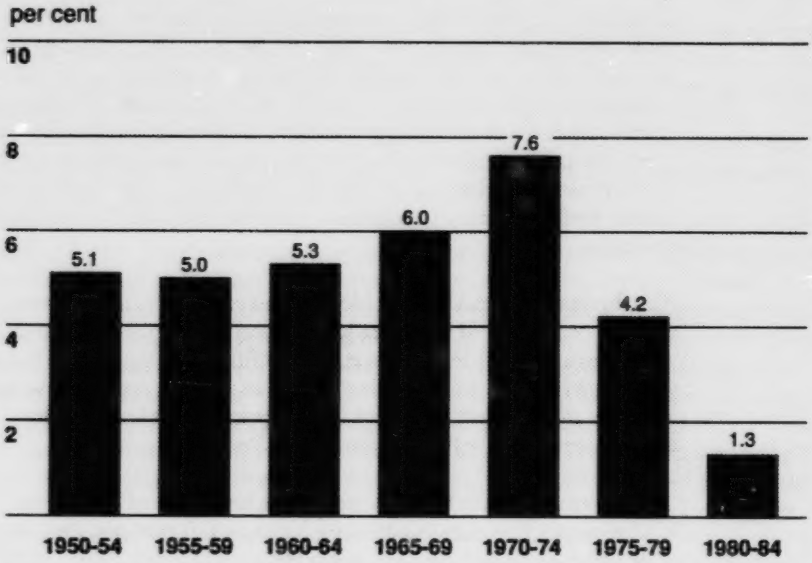
The government has built a strong basis for this kind of progress. In 1984, it set out a comprehensive plan to achieve economic renewal and the benefits that flow from it. It presented tough budgets, most recently in April 1989 and February 1990, designed to achieve fiscal consolidation by the mid-1990s. And measures in the 1991 budget complement and build on the policies undertaken over the last six and one-half years

THE CHALLENGE

In 1984, the Canadian economy was at a crossroads. Living standards established by long years of economic growth and productivity gains were threatened. A major reason was that the fiscal policy practised between 1950 and 1973 had given way to a decade of excessive expenditure growth funded by borrowing. This fuelled inflation pressures, reduced economic efficiency and increased debt burdens. The government in 1984 faced the challenge of reviving the policy environment that had produced the prosperity of the 1950s, 1960s and early 1970s. Otherwise, Canadians faced the real risk of having, not just low growth in living standards, but actually lower living standards.

Chart 1 shows the steady progression of Canadian real income from 1950 to 1974 and the subsequent deterioration from 1974 to 1984. Average annual growth in real net national income dropped from well over 5 per cent in the earlier period to only 1.3 per cent by the early 1980s. Differences in external economic circumstances were partly responsible. Increases in crude petroleum prices engineered by OPEC stoked inflation pressures; other commodity prices also increased. But the

Chart 1
Real net national income[1]
five-year averages of annual growth rates



[1] Net national income is deflated by the implicit consumption deflator.

deterioration reflected a contrast in policies as well. The total government sector was in balance and the federal government ran a small surplus in the pre-1974 period (Table 1); in contrast, both the federal and combined levels of government had substantial deficits between 1974 and 1984. Total government expenditure as a percentage of GDP increased greatly after the early 1970s. Similarly, while the debt-to-GDP ratio of the government sector had declined significantly between 1950 and 1973, it increased at double-digit rates in the 1974-1984 period; the debt growth of nearly 25 per cent far outstripped the growth in the economy.

Such policy differences contributed to a dramatic contrast in economic performance between the periods 1950-1973 and 1974-1984: average annual real GDP growth fell from 5.2 per cent in the first period to 3.3 per cent in the second; average annual labour productivity increases of 2.9 per cent in the first were more than halved in the second; and average annual inflation of 2.8 per cent in the first more than tripled to 9 per cent in the second. In the earlier period, with productivity increases averaging 2.9 per cent a year, workers could expect their standard of living to double within 25 years – about the length of one generation. In the later period, with increases in productivity of 1.1 per cent a year, they could only expect to double it in over 60 years – nearly a lifetime.

Table 1
Importance of a supportive macroeconomic environment for strong, sustainable growth

	1950-1973	1974-1984
	(per cent)	
Macroeconomic environment		
Inflation rate (CPI)	2.8	9.0
Deficit/GDP		
Federal	-0.4	3.5
Total government	0.0	3.1
Government expenditure/GDP		
Federal	16.4	20.9
Total government	29.2	41.4
Debt[1]/GDP		
End of period level		
Federal	5.0	29.2
Total government	7.2	26.7
Average growth rate during period		
Federal	-9.2	17.4
Total government	-7.9	12.7
Results: indicators of prosperity		
Real output growth	5.2	3.3
Commercial sector labour productivity growth	2.9	1.1

[1] Debt is measured on a national accounts basis.

THE GOALS OF ECONOMIC POLICY

By the mid-1970s Canadians appeared to take prosperity for granted. The enormous surge in productivity and real incomes in the 1950s, 1960s and early 1970s carried our standards of living to the fore among industrial countries. Such growth was not accidental, nor was it preordained. It resulted from sound economic and fiscal management by all levels of government: low and stable inflation, no persistent government deficits, a relatively small government sector, and strong efforts by the private sector to raise productivity growth.

These lessons were increasingly discarded over the 1974-1984 period: governments let inflation rise and spent more than they were willing to tax, driving up deficits and debt. By 1984, Canadians received $1.33 in goods, services and programs from the federal government for each tax dollar they sent to Ottawa. But there was no free lunch: governments could not provide something for nothing, they were merely financing current consumption with debt. Economic growth declined, as did private-sector productivity. The private sector was battered on two sides: by increasing government intervention, expenditure and taxation, and by increasing global competition – competition it was slow to understand and meet.

The government's economic focus since 1984, as outlined in the 1984 Agenda for Economic Renewal, has been to reverse the course of the 1974-1984 period in order to create a stronger, more vibrant economy, one capable of steadily increasing the living standards of Canadians. To achieve these objectives, the government has had two complementary policy thrusts.

One thrust was structural initiatives to reduce distortions and impediments to growth, to open and assure access to markets, and to encourage investment – in short, to give the private sector greater freedom and opportunity to contribute to improving the performance of the economy.

The other, and equally important, thrust was to create the right macroeconomic environment for the economy to realize its potential. The government has had to squarely face the dynamics of the vicious circle of deficits and debt. It has acted, and continues to act, to restore stability to the fiscal situation by reducing the federal government deficit. Creating the right macroeconomic environment has also required action to counter inflation pressures, put inflation on a downward track, and create room for the private sector to grow and expand by reducing the government sector's demands on the economy's scarce resources.

The corner has still to be securely turned. Since 1984, inflation has averaged 4.4 per cent, less than half the level of the previous 10 years, but still well above the average of 2¾ per cent from 1950 to 1973. The debt-to-GDP ratios of the federal and total-government sectors have continued to rise over the last six years, although at a quarter of the pace of the previous 10 years. The operating deficit of $16 billion in 1984-85 has been turned into an operating surplus of $12½ billion in 1990-91. The federal government deficit as a percentage of GDP has fallen 4.2 percentage points since 1984-85, but remains too high at 4.5 per cent. Further efforts must be made to turn the fiscal corner. This budget builds decisively on earlier actions.

RELATING ECONOMIC AND FISCAL GOALS

Canada can again achieve the rapid growth in incomes of the pre-1974 period. To do so, inflation must be reduced and kept low; debt burdens must be lowered, and the economy must be made more productive.

These are ambitious tasks, but the opportunities exist to accomplish them. New production technologies can raise productivity and, in turn, real incomes. Consumers are demanding new and better products, and an improved environment through more efficient and careful use of scarce resources. Trade will continue to grow as world markets for Canada's goods and services expand and new markets are created. The countries of Eastern Europe are taking their place in the world economy. The dynamic Asian economies of the Pacific Rim have grown, enlarging world markets. The countries of South America, by reducing barriers to trade and impediments to growth, are doing the same. In short, potential markets for Canada's goods and services are expanding rapidly: we have to produce the right goods at the right price to benefit from these opportunities.

The Canadian economy must be flexible enough to meet international challenges and adjust production to take full advantage of growing world markets. To satisfy these goals and also supply the goods and services Canadians want, the economy must expand its productive capacity. The keys are to raise the quality and the quantity of investment in plant, machinery and equipment, the skill level of the labour force, and the efficiency with which all factors are combined to produce output. These improvements will raise the living standards of Canadians.

The government has already implemented numerous structural reforms and is undertaking new ones to raise the country's potential for economic growth. Tax reform has increased productivity and will continue to do so by increasing incentives for Canadians to work and invest, and by reducing the extent to which economic decisions are based on tax-related incentives more than real production opportunities. The Canada-United States Free Trade Agreement offers opportunities to increase productivity by encouraging the introduction of leading-edge technologies and by allowing Canadians to specialize and expand productive capacity in areas where they are most efficient. Other initiatives that are making the economy more efficient and competitive include: deregulating the energy and transportation sectors, privatizing 18 Crown corporations and dissolving eight that no longer served a useful public policy role, adopting a Labour Force Development strategy that will help to develop the skills of the labour force and match those skills to the needs of the economy, revamping business framework policies, enacting financial sector reform, and reforming the unemployment insurance system to maintain the basic nature of the program while reducing disincentives to work. The increase in potential growth from these initiatives will translate directly into increases in real incomes for Canadians.

The government's medium-term macroeconomic strategy complements these structural initiatives by creating the right macroeconomic environment for strong and sustainable growth. In this sense, the macroeconomic strategy is a structural initiative: both structural and macroeconomic policies serve the same objective – increasing production potential and living standards. Inflation and its attendant inflationary psychology must be dealt with. The last 15 years have shown that high inflation conflicts with strong growth in productivity and real incomes. The government is therefore firmly committed to putting the Canadian economy on a steady course towards price stability. Similarly, large deficits and rising debt burdens conflict with a vibrant and prosperous economy: restoring fiscal balance is a prerequisite for longer-term prosperity.

The government's Plan for Economic Recovery embodies these objectives. Restoring fiscal balance means reducing the growth of the public debt to no more than the growth of the economy, achieving continuing, sizeable reductions in the budgetary deficit, and eliminating the requirement to borrow on private markets. In detail, these fiscal steps are essential ingredients in the government's Plan for Economic Recovery.

Stabilizing the debt-to-GDP ratio

At its core, Canada's budgetary problem is a debt problem. The stabilization of the debt-to-GDP ratio (that is, reducing the growth of debt to below the growth of the economy) is the key to regaining control of the government's budgetary situation.

Sizeably reducing the budgetary deficit

The debt-to-GDP ratio can only be stabilized by sizeably reducing the budgetary deficit. This also signals that the government has made the structural changes necessary to put its fiscal house in order – in effect, establishing a large and growing operating surplus to offset the compounding cost of servicing debt.

Moving the government's financial requirements into surplus

Government financial requirements now absorb domestic savings, competing on capital markets for scarce funds and putting upward pressure on interest rates. Moving the government's financial requirements into surplus will add to saving: a greater share of private domestic saving will then be available for productive investment, rather than financing unproductive government deficits. This will reduce the cost of capital for companies that need capital to grow.

Reducing program spending relative to GDP

Too much government – or inefficient government – impedes the functioning of the market. Governments at all levels play a vital role in providing public goods and improving the functioning of markets in areas where market failures occur. But a large and inefficient government sector is seldom compatible with a competitive and dynamic private sector.

CREATING THE RIGHT MACROECONOMIC ENVIRONMENT

The fiscal anchors described above are crucial to the Plan for Economic Recovery as they help to create the right environment for expansion and prosperity. We will only achieve this environment if we attain a low and stable inflation rate, move towards fiscal balance, reduce the debt burden on the economy, and direct a smaller share of economic resources to the total government sector, leaving more room for the private sector.

Co-ordinating policy to achieve price stability

Low inflation is a key to growth in productivity and potential output. When money maintains its value, an atmosphere of confidence and stability reduces risks and stimulates investment in physical and human capital and new technologies. Part of the policy success of the 1950-1973 period was maintaining a low and fairly stable inflation rate.

The contrasting economic results of the 1950-1973 and 1974-1984 periods highlight the importance of controlling inflation to maintain strong economic performance. They also demonstrate that co-ordinating fiscal and monetary policies to control inflation is a key to robust and stable economic performance: monetary policy should not bear the entire burden. After 1973, the fiscal performance of the total government sector deteriorated into increasing deficits and rising public debt. Inflation rose significantly (Table 2). Firm monetary policy between 1980 and 1984 brought inflation down significantly from its peak of 12.5 per cent. But, the burden of controlling inflation was left entirely to monetary policy; government deficits continued to rise and public debt increased rapidly during this period.

Canada's inflation rate fell to a 14-year low of 4 per cent in 1985; a combination of anti-inflationary monetary policy and restrictive fiscal policy kept it at about that level until late in 1988. Chart 2 shows that fiscal policy moved significantly toward restraint between 1985 and 1988 – both the actual total government national accounts balance and the federal discretionary balance (the federal national accounts balance adjusted to remove debt interest payments and the effects of cyclical variations in economic activity) rose. By late 1988, however, inflation pressures began to mount as the rapid expansion of the Canadian economy created excess demand for goods, services and labour and a worrisome inflationary psychology emerged (Chapter 5). At the same time, the total government fiscal balance unfortunately moved towards fiscal ease, as federal discretionary restraint was offset by expansion at other levels of government, primarily Ontario, and by the impact ofrising inflation pressures. Consequently, the greatest burden of controlling inflation in the past two years has fallen on monetary policy. Real interest rates rose and the nominal and real interest differential between Canada and the United States reached very high levels.

Table 2
Short-term interest rates and inflation

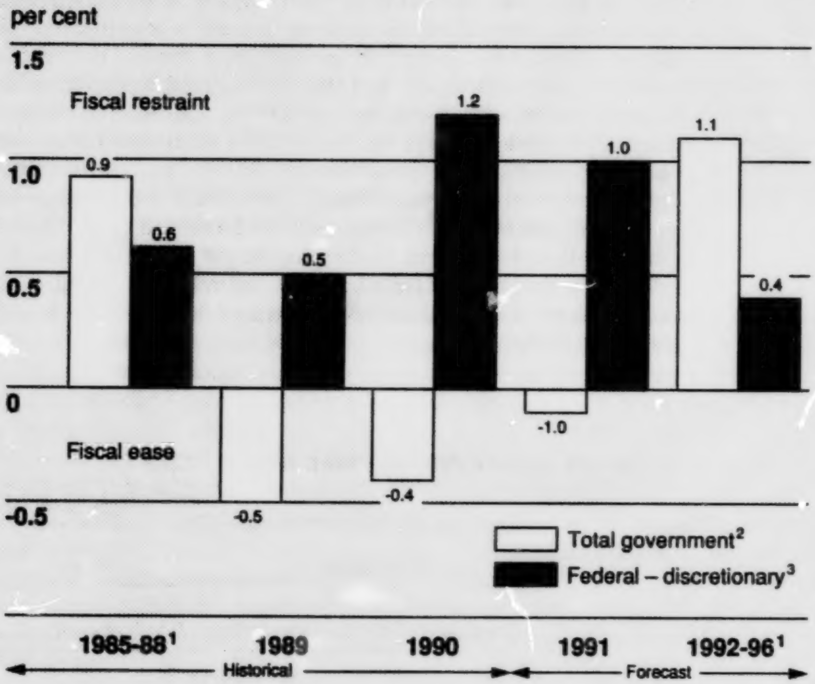
				90-day commercial paper rate			
	CPI inflation			Canadian		Canada-U.S. differential	
	Canada	United States	Differential	Nominal	Real	Nominal	Real
				(per cent)			
1956-73	2.9	2.8	+0.1	5.2	2.3	0.4	0.3
1974-80	9.3	9.2	+0.1	9.9	0.5	1.2	1.1
1981-84	8.3	6.0	+2.3	13.3	4.9	1.2	-1.1
1985-90	4.4	3.9	+0.5	10.3	5.9	2.4	1.9
1990-91	5.2	5.3	-0.1	11.4	6.2	3.2	3.3
1992-96	2.4	3.8	-1.4	7.4	5.0	0.0	1.4

Sources: Statistics Canada, U.S. Department of Commerce and the Department of Finance.

High real interest rates caused by policy imbalances have large-scale consequences for productive potential and international competitiveness. The cost of acquiring and using investment goods rises, not only because of higher interest rates, but also because of an increase in risk caused by inflation-related uncertainty. High real interest rates consequently undermine the expansion of potential output and reduce purchases of investment goods. They distort spending patterns toward short-term consumption and away from projects for expansion. They put upward pressure on the exchange value of the Canadian dollar. Net exports are reduced – effectively crowded out by excess government consumption.

Chart 2

Stance of fiscal policy



[1] Average.

[2] Change in the actual national accounts balance, total government sector, expressed as a per cent of GDP.

[3] Change in the federal government national accounts primary balance adjusted to remove all effects of cyclical variations in economic activity expressed as a per cent of GDP. This follows a standard methodology used by such institutions as the Organization for Economic Co-operation and Development. See for example OECD December 1990 Economic Outlook.

Establishing an appropriate mix of fiscal and monetary policy is essential to generate the conditions for a strong recovery and durable expansion. Strong actions to spur fiscal consolidation will reduce pressures on interest rates and the exchange rate. This will encourage investment. It will also create room for exports to expand.

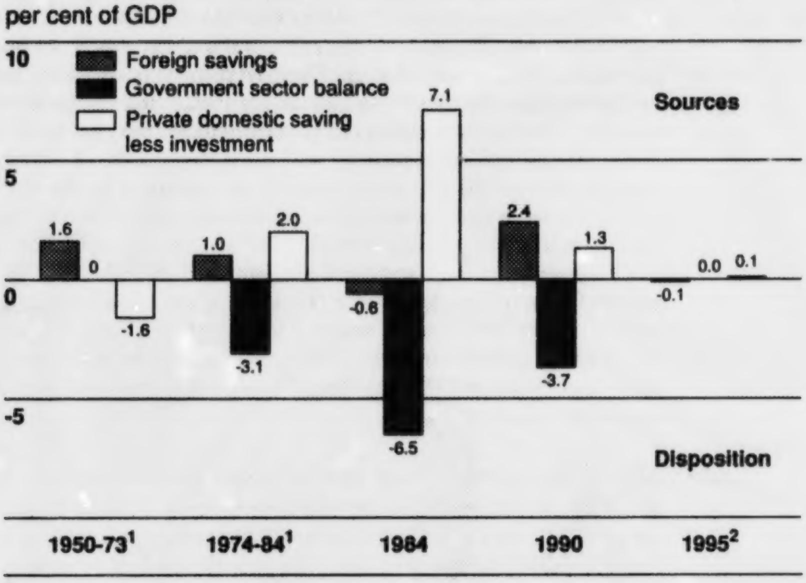
This budget establishes both the structural and fiscal policies required to achieve low and stable rates of inflation. The government is attacking inflationary psychology directly by setting clear interim inflation targets along the path to price stability. Chapter 5 describes the government's strategy for achieving price stability. The government's wage strategy will assist the process of adjusting inflation expectations. Additional fiscal restraint, as measured by the change in the federal and total government-sector balances on a national accounts basis, reduces the burden on monetary policy over the 1991 to 1996 period (Chart 2). The improved mix between monetary and fiscal restraint will allow both nominal and real interest rates to fall in the medium term (Table 2), producing a beneficial circle of lower deficits, lower debt charges, and still lower deficits. Canada's improved inflation performance relative to the United States will allow short-term interest rates to fall to U.S. levels and the differential to shrink to zero. All of this will underpin the expansion.

Reducing public-sector use of scarce domestic savings

Business real investment must continue to grow strongly to assure that we obtain the medium-term economic benefits of the structural reforms. Increased investment cannot be taken for granted; it requires an appropriate economic and fiscal environment. From 1984 to 1989, businesses responded vigourously to the incentives provided by government policy: business real non-residential investment relative to GDP reached 13.6 per cent in 1989, its highest level since 1981. But investment needs to be financed, either through domestic saving or foreign borrowing.

Canada has historically required foreign savings to finance the high rate of private-sector investment needed to expand its economy. For example, in the 1950-1973 period, foreign borrowings were common even with balanced government fiscal positions (Chart 3a). In the 1974-1984 period, however, private domestic saving rose relative to investment (Chart 3b), but government dissaving – deficits arising from borrowing to finance current consumption – also increased. In 1984, only high net private domestic saving in the aftermath of the 1981-1982 recession offset massive dissaving by the public sector. Since 1984, the total government sector has gradually reduced public-sector dissaving but not at a sufficient pace to accommodate the private sector's increased demands for funds. Net private sector domestic saving – the excess of private domestic saving over investment – has decreased more rapidly than government dissaving, owing to a surge in business investment spending since 1986. Increasingly, foreign borrowing has been required to finance the shortfall, resulting in rapidly rising foreign indebtedness and demands on Canadian resources to service that debt (Chart 4).

Chart 3a
Sources and disposition of savings



[1] Average.

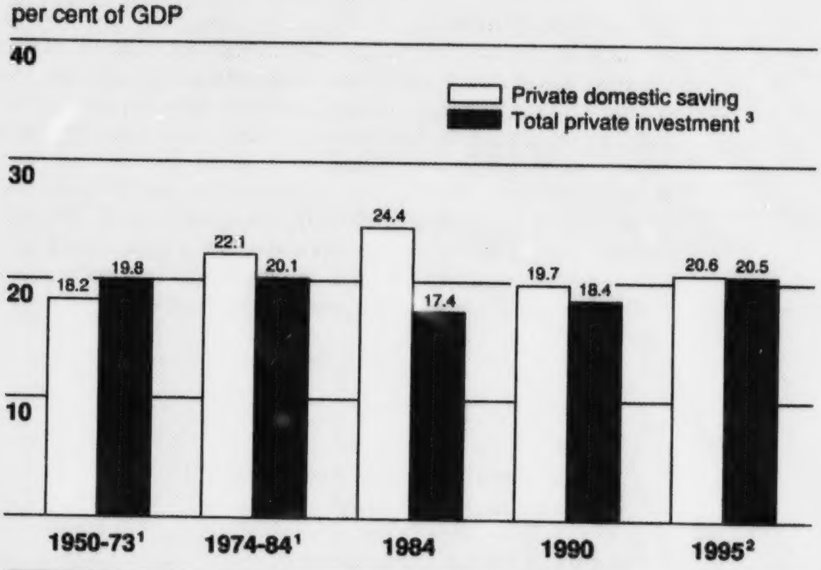
[2] Forecast.

The relation between the public sector debt and foreign borrowing is striking. The evolution of the federal debt relative to GDP (and the cost of servicing that debt) closely parallels the evolution of the cost of servicing Canada's foreign debt. At the end of the Second World War, Canada's public and foreign debts were large. The subsequent strong effort to reduce the public debt resulted in a rapid decline in the cost of foreign debt service. Conversely, the build-up of public debt after the early 1970s was matched by increasing payments abroad to cover the cost of foreign borrowing.

Lowering the reliance on foreign savings by raising domestic savings will result in more of the benefits of a strong economy accruing to Canadians in the form of higher incomes. The share of Canadian domestic production paid abroad to service the foreign debt will be reduced. Tax reform encouraged domestic saving by reducing marginal tax rates and strengthening the role of consumption taxes. As well, government-sector dissaving, which uses up scarce domestic saving, must be reduced. Measures announced in this budget reinforce the April 1989 and February 1990 budget objective of eliminating federal government borrowing on private capital markets by 1994-95. By then the federal sector will be adding to private domestic saving after subtracting from it for so many years.

Chart 3b

Private domestic saving and investment



[1] Average.

[2] Forecast.

[3] Residential and non-residential business investment plus inventory investment.

Sources: Statistics Canada and Department of Finance.

Reducing size and role of government

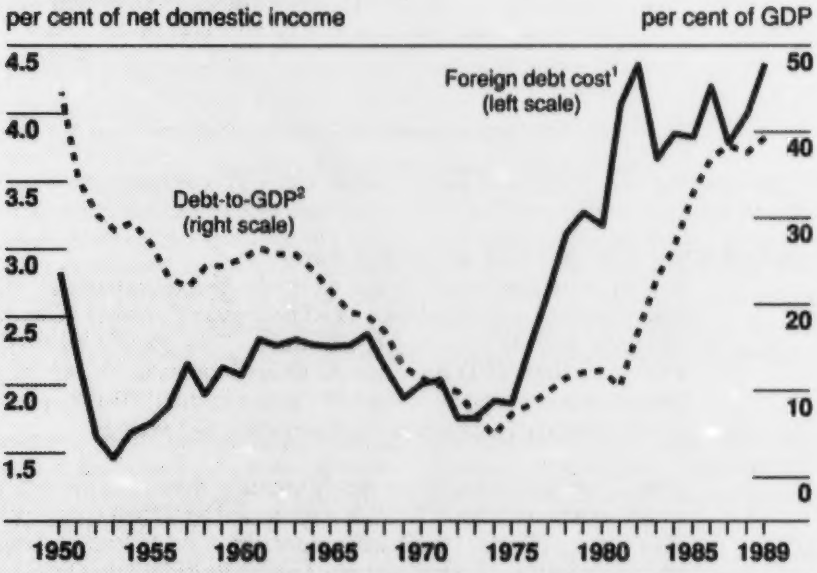
In 1984, government spending at all levels – federal, provincial, municipal, hospitals and pensions – accounted for over 45 per cent of Canadian gross domestic product, compared with 37 per cent a decade earlier. This rise was more rapid than the average for the OECD countries. As Chart 5 indicates, the size of government in Canada was about equal to the G-7 average in the 1960-1973 period; by 1984, it was nearly 6 percentage points of GDP above the G-7 average.

After 15 years of more or less steady increase, the size of the total government sector, as a percentage of GDP, has decreased by 2½ percentage points since 1984. This decline resulted largely from reduction of the federal government sector; excluding federal transfers, aggregate expenditure by other levels of government as a share of the economy was roughly unchanged. This is a particularly important result since the provincial, local, and hospitals (PLH) sector has grown much faster than the federal sector and is now larger (Chart 6). Thirty years ago, in 1961, the PLH sector was only 15 per cent of GDP, 2½ percentage points smaller than the federal sector; by 1990, it had increased to 25.6 per cent of GDP, 3.4 percentage points larger. Increased PLH sector spending has been accompanied by increased taxation: revenues in this sector rose from 14 per cent of GDP in 1961 to almost 25 per cent in 1990.

Because Canada must export into an increasingly competitive global environment, we must be vigilant that neither the amount of Canadian taxation – the inevitable consequence of a particular level of expenditure – nor the tax structure put us at a competitive disadvantage. Federal government policy since 1984 has focused on reducing the size of the federal government as the main approach to fiscal consolidation. Program spending has declined from 19.5 per cent of GDP in 1984-85 to 16.0 per cent in 1990-91. The February 1991 budget continues these trends: after some upward movement in 1991-92, reflecting both the effect of the recession on unemployment insurance benefits and depressed grain markets on farm support payments, program expenditures will decline to 14.5 per cent of GDP by 1995-96, well below the average for the period 1950-51 to 1973-74 (Chart 7).

Chart 4

Cost of servicing the foreign debt[1] and debt-to-GDP ratio[2]



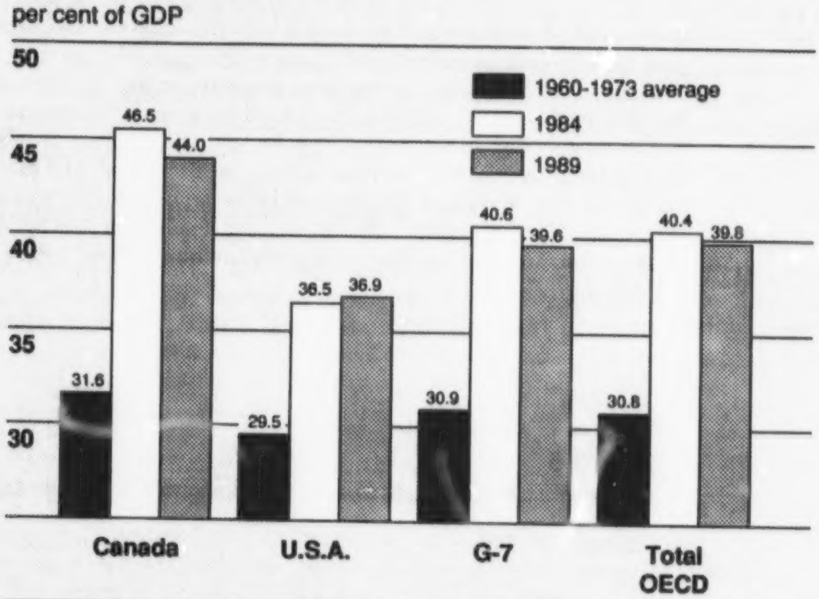
[1] Difference between net domestic income and net national income – essentially net interest and dividends paid abroad – as a per cent of net domestic income.

[2] Total government sector debt on a national accounts basis as a per cent of GDP.

Sources: Statistics Canada and Department of Finance.

Chart 5

Size of government:
general government[1] total outlays
international comparison



[1] Includes federal, provincial and municipal governments.

Sources: OECD December 1990, *Economic Outlook;* Data Resources Incorporated; and Department of Finance.

Establishing fiscal stability

Fundamentally, fiscal stability in Canada requires reducing the burden of debt. In practice, this means we must make the structural changes in expenditures and revenues required to generate growing surpluses in the operating balance needed to first stabilize and then reduce the debt-to-GDP ratio. In addition, we must reduce debt servicing payments, in part by reducing inflation and allowing interest rates to decline, and also by reducing government deficits.

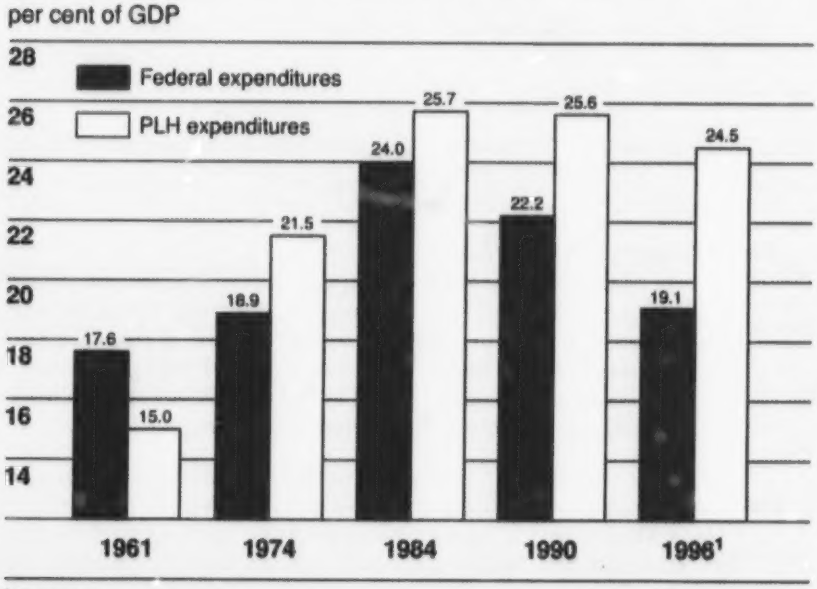
Since 1984, when the government began its medium-term fiscal strategy, the operating balance has gone from a deficit of $16.1 billion to a surplus in 1990-91 of $12.4 billion (Chart 8). The government has brought about this improvement by actions in areas where it has most control: program spending has been curbed (see Chapter 3); revenue yields have been restored to their average levels of the 1960s and 1970s. In spite of these substantial gains, large and rising interest payments on the public debt have offset much of the improvement in the operating balance. The deficit remains near $30 billion.

In short, the medium-term fiscal problem is very much a debt problem. The government debt rose from $48 billion in 1973-74 to $206 billion in 1984-85, then to $388 billion in 1990-91. A full 90 per cent of the increase over the last six years represents the compounding of interest on the accumulated debt of 1984-85. The debt-to-GDP ratio is now 57.3 per cent, an increase of about 40 percentage points since 1973-74.

Public debt charges are still growing at a double-digit rate and now use up almost 35½ cents of each revenue dollar (Chart 9), three times more than in 1973-74. More than $40 billion in revenues has to be generated to pay the interest on the debt. Further, each year the deficit adds to the debt. Interest compounds on interest: a deficit in the range of $30 billion adds more than $3 billion to debt interest payments at current interest rates in the next fiscal year, $3.3 billion in the following year, and so on. The debt and debt service charges are increasing relative to the size of the economy – that is, the debt-to-GDP ratio is increasing – and faster than the incomes of Canadians and government revenues. Such a situation is unstable.

Chart 6

Growth in the federal and PLH sectors in Canada



¹ Forecast.

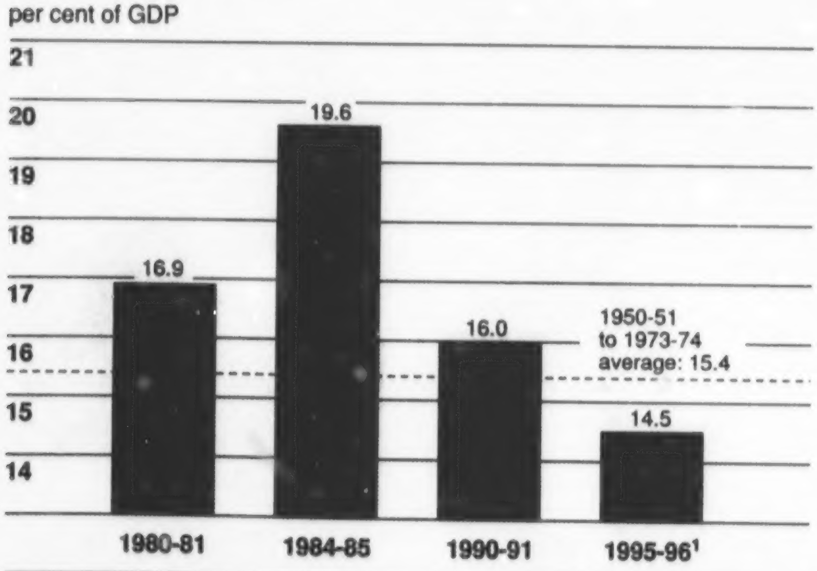
Sources: Statistics Canada and Department of Finance.

The actions taken in this budget build on the measures of previous budgets to further strengthen the fiscal situation of the federal government. The debt-to-GDP ratio stabilizes in 1991-92 and declines steadily thereafter (Chart 10). A substantial reduction in the public accounts deficit as a share of GDP – down to under 1 per cent by 1995-96 – contributes to this stabilization and decline in the debt-to-GDP ratio (Chart 11). The main source of this fiscal consolidation is expenditure restraint: by 1995-96 federal program expenditures as a percentage of GDP fall to 14.5 per cent, almost a full percentage point below the average from 1950 to 1973 (Chart 7). As a result, debt-servicing costs as a percentage of each revenue dollar are projected to decline to 25.9 cents by 1995-96. Inflation control is also essential. This will contribute to a decline in debt-servicing costs as a share of GDP by putting in place the conditions for interest rates to decline.

Maintaining a consistent policy environment

All stakeholders in the economy gain from an economic environment conducive to increasing productivity and living standards; all have a role to play in creating such an environment. This budget takes forceful steps to improve the environment for durable economic growth: putting the fiscal framework on a solid footing to achieve

Chart 7
Size of federal government: program expenditures



[1] Forecast.

Source: Department of Finance.

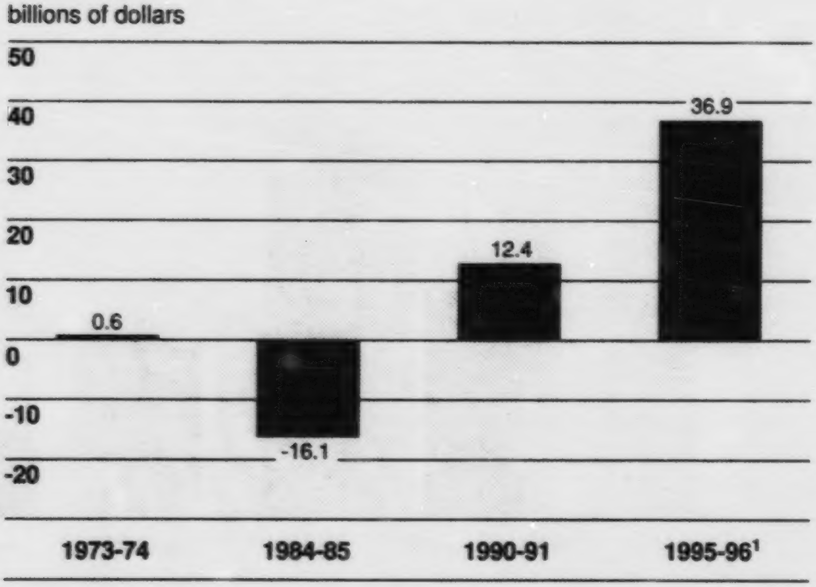
zero financial requirements by 1994-95; legislating caps on program spending to assist in achieving this fiscal objective; setting explicit inflation targets to guide expectations on the path to price stability; and giving strong leadership on wage policy.

Action is needed by all levels of government, however, not just the federal government. Governments must co-operate to establish the right general economic policy environment. The PLH sector is larger than the federal public sector; the activities of provincial governments can have important economic implications. We must achieve more co-ordination of fiscal policy between levels of government.

The appropriate environment is not set by governments alone. Chapter 7 discusses the ways business and labour can act to raise productivity and living standards. These include vigorously adopting new and more efficient technology, undertaking research and development, adopting and following training programs to improve skill levels, and changing the ways they operate in the work place.

Chart 8

Operating balance



[1] Forecast.

Source: Department of Finance.

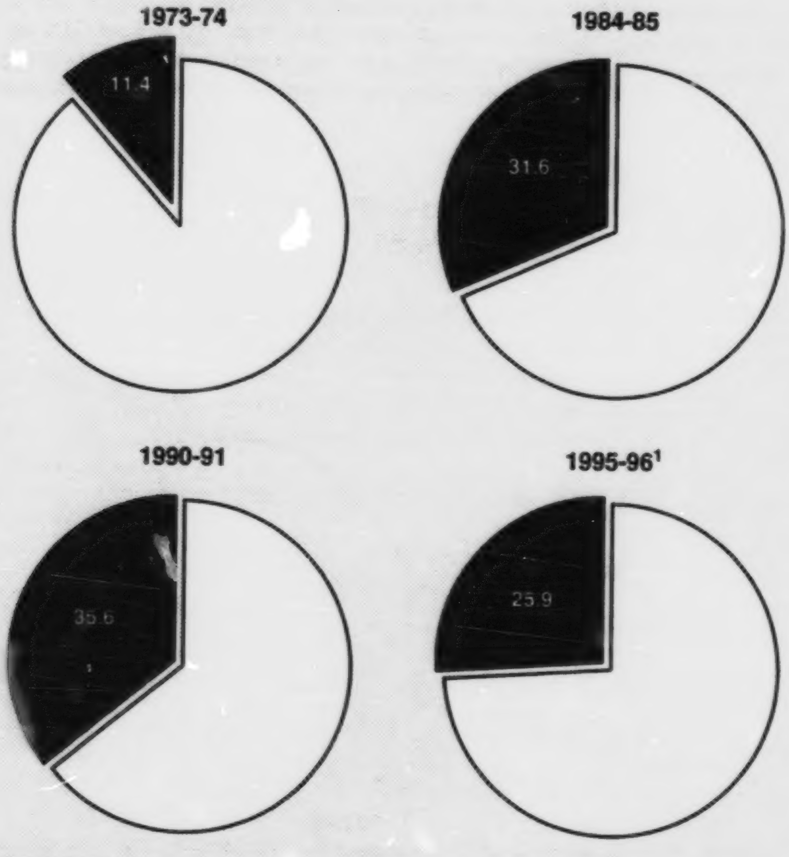
MEDIUM-TERM FISCAL GOALS

The federal government has taken further strong action, as outlined in Chapter 4, to restore fiscal stability:

- The steady decline in financial requirements begun in 1984-85 reaches a critical goal: the need for new government borrowing on private capital markets is eliminated – for the first time since 1969-70 – by 1994-95 (Chart 12). Private

Chart 9

Debt interest payments as a percentage of budgetary revenues



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[1] Forecast.

Source: Department of Finance.

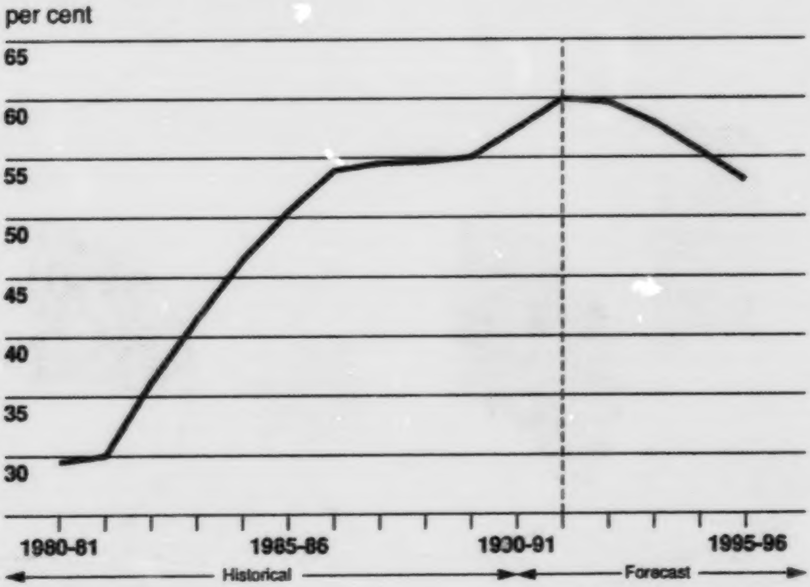
sector saving will then be fully available to finance private sector investment. The need for foreign borrowing and debt servicing diminish and Canadian incomes and living standards increase.

- Program spending declines steadily as a proportion of GDP and stands at 14.5 per cent by 1995-96, well below the average of the 1950-1973 period (Chart 7). This reduces the intrusions of the fiscal affairs of the government into the private sector. It gives the private sector more room to manoeuvre.
- The debt-to-GDP ratio stabilizes in 1991-92 and declines through the medium term (Chart 10). This reverses the experience since 1974 of debt growing faster than the economy each year, and of public debt charges growing faster than revenues.
- The fiscal plan meets the targets adopted in the April 1989 and February 1990 budgets in spite of the difficulties created by the recession, continued strong inflation pressures, and higher-than-expected interest rates. The budgetary deficit falls to $6.5 billion, or less than 1 per cent of GDP, by 1995-96 (Chart 11). The budgetary deficit is the single most publicized budgetary variable. Its reduction is crucial to increasing confidence in financial markets in Canada.

Chart 10

Federal debt-to-GDP ratio[1]

1980-81 to 1994-95



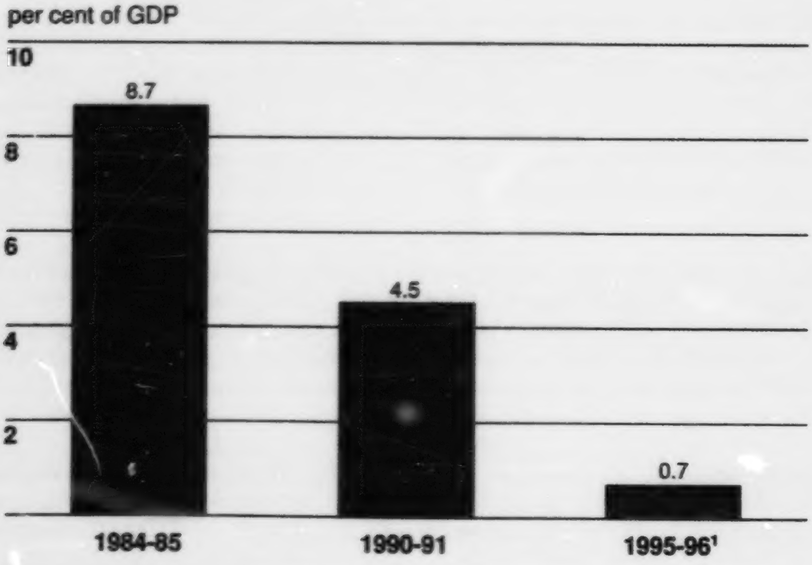
[1] Public accounts basis.

Source: Department of Finance.

- The changes in the fiscal structure required to establish fiscal stability have been made. The operating balance continues to increase, reaching a surplus of $36.9 billion by 1995-96 (Chart 8).
- On a national accounts basis, the federal government is in balance in 1995. The use of scarce domestic saving by the government sector, as measured in the national accounts, is eliminated.
- To put these improvements in perspective, it is worth noting that Canada's financial requirements are comparable to the unified budget deficit in the United States. As a proportion of GDP, financial requirements in Canada in 1990-91 will be 3.5 per cent. For the U.S. in fiscal year 1991, their deficit is estimated to be 5.7 per cent of their GNP. Looking ahead, Canadian financial requirements will be eliminated in just four years – in fact there will be a surplus.

In these ways, it is clear that the essential contribution the federal government is making through its Plan for Economic Recovery is to establish fiscal stability and take the structural actions necessary to reduce inflation expectations and pressures. This sets the stage for improved economic performance.

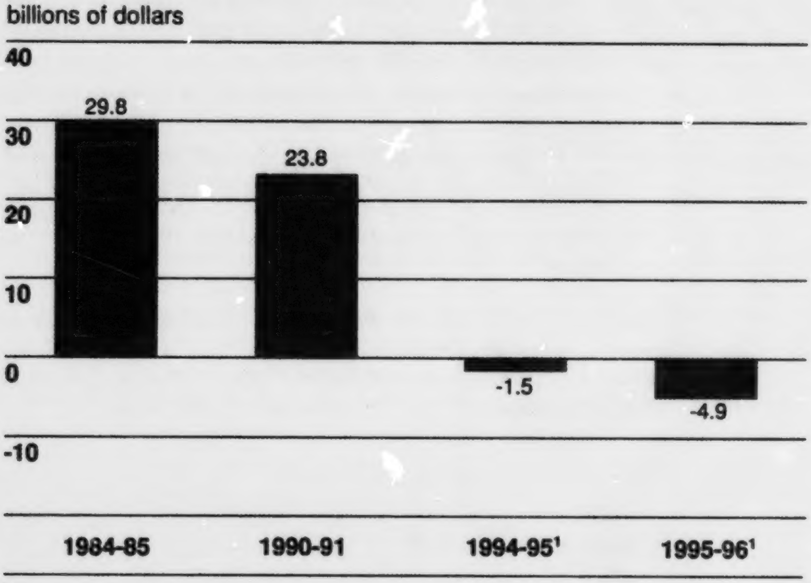
Chart 11
Budgetary deficit



[1] Forecast.

Source: Department of Finance.

Chart 12
Financial requirements



[1] Forecast.

Source: Department of Finance.

CHAPTER 7: SECURING CANADA'S PROSPERITY: BUILDING AN AGENDA FOR LONG-TERM GROWTH IN LIVING STANDARDS

INTRODUCTION

As we look beyond the current economic situation to the latter half of the 1990s and to the next century, Canadians need to begin thinking seriously about what more needs to be done to achieve future improvements in our living standards. Although we have managed to attain one of the highest standards of living in the world and a quality of life second to none, there is no guarantee that such progress will continue. Steadily rising prosperity must be earned.

There are clear warning signs that simply relying on the things that have helped us succeed in the past will not be enough to improve further our material welfare and quality of life. The most telling indicator of the economic challenges ahead is our productivity performance. Productivity is a measure of how efficiently goods or services are produced from the nation's resources – labour, capital and materials. Improvements in productivity generate gains that can be distributed to workers in the form of higher real income and to employers in the form of higher profits.

Canada's productivity growth record has been deteriorating. From 1974 to 1989, overall productivity growth fell to a quarter of its average level in the previous 20 years. In the first half of the 1980s, overall productivity did not grow at all. The trend in labour productivity in the manufacturing sector is especially disturbing. Although we made impressive gains to close the gap with the U.S. in the postwar period, reaching almost 83 per cent of U.S. manufacturing labour productivity levels by 1980, the gap has been widening since then.[1] Over the past 15 years, Canada has fallen to fifth from second place in the G-7 in manufacturing labour productivity. Competitor nations such as West Germany, Italy and France have caught up to, and surpassed, our productivity levels.

These trends in Canada's productivity growth are cause for serious concern and have been the subject of growing study. The National Advisory Board on Science and Technology, the Economic Council of Canada, the Canadian Labour Market and Productivity Centre, the Canadian Manufacturers' Association, the Canadian Chamber of Commerce and others have all drawn attention to problems of weak productivity growth and its implications for Canada's prosperity.

The federal government for its part is supporting an in depth study on the strengths and weaknesses of Canada's competitiveness that has been commissioned by the Business Council on National Issues. The Prime Minister has asked the Economic

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[1] See *Trends in Canada's Competitive Position*, by P.S. Rao and T. Lemprière, Economic Council of Canada, 1990.

Council of Canada to carry out a major study of the impact of governments on Canadian competitiveness. And the government will be releasing a discussion paper on Canada's long-term prosperity in the spring.

REINFORCING OUR PROSPERITY

In its 1984 Agenda for Economic Renewal, the government recognized the central importance of these issues. Canada's policies in the 1970s and early 1980s were undermining our long-term productivity performance. Governments became too intrusive in the economy, not only through large deficits and rapidly growing debt, but also massive spending on subsidy programs that too often rewarded effort rather than success. Transfer programs to individuals often dulled incentives to work, save and invest. Activities of Crown corporations often interfered with the efficient operation of the private sector by diverting significant resources away from more efficient, productive activities. The tax system encouraged decision-making for tax rather than economic reasons. The regulatory burden was overly complex and led to hidden costs for business.

Canada needed to change course. The challenge was to put in place policies that would reinforce the country's capacity to support the high standard of living that Canadians enjoyed and wanted to enhance. The Agenda for Economic Renewal pointed to the need to restore fiscal balance to establish a stable macroeconomic environment, based on low and stable inflation, and conducive to high levels of saving and investment. It also highlighted the importance of a sound economic framework for business and labour to reinvigorate the private sector. Only through such a comprehensive approach that integrated both macroeconomic and microeconomic policies could Canadians realize their economic potential and secure long-term growth of living standards.

Since 1984, significant progress in implementing this agenda of reform has been achieved. Canadian enterprises and workers have begun to seize new opportunities. The government's structural reforms are expected to increase productivity growth in the first half of the 1990s by about 0.6 per cent annually. But our major competitors have been improving their productivity at twice to four times this rate. More needs to be done.

A stable macroeconomic environment, the subject of discussion in previous chapters, is vital to sustained improvement in our productivity. The government must foster the right balance of broad macroeconomic policy that will lead to fiscal balance, price stability and permanently lower interest rates. Until that is achieved, the environment for private sector investment is less attractive and the capacity of government to support important policy initiatives is restricted. This budget takes up the challenge of firmly entrenching macroeconomic stability by restoring fiscal balance and by setting inflation targets.

Stakeholders other than the federal government have important roles to play as well. Provincial governments in Canada, through their budgetary policies, their wage settlements, and the prices they set for certain goods and services can play an important role in creating a sustainable, non-inflationary framework for growth.

Business and labour must also take a responsible approach to wage-setting. Wage increases that are consistently out of line with productivity gains will make the task of lowering inflation more difficult, put upward pressure on real interest rates, and cause loss of jobs. Our ability to sell our goods internationally, and ultimately our living standards will be affected.

Over time, the living standards of Canadians can be raised only by increasing productivity. High growth of productivity requires a sound business climate that encourages risk taking and innovation. In such an environment, productivity can be raised by improving the quality and effectiveness of the key productive resources of our economy, capital and labour. Improvement will require structural or microeconomic policies which promote:

- investment in the skills and training of Canadians,
- investment in physical capital embodying more productive, leading edge technologies,
- improvements in the way we organize and manage the production of goods and services, and
- putting capital and labour to higher value-added uses.

IMPROVING THE QUALITY OF OUR INPUTS

Better capital and technology

Productivity growth comes about through investment in the quality and efficiency of the inputs – capital, labour, management and entrepreneurship – that go into the production of our goods and services. Put simply, productive investments raise our future living standards.

A business decision to purchase a new piece of equipment is typically a decision not only to invest in new technology but also to invest in upgrading the skills of the work force to match the requirements of the new technology, and often to invest in new management techniques to ensure that the new equipment, technology and skills of labour are combined to take full advantage of the opportunity.

Governments too invest in assets essential to the country's productivity and prosperity: in physical infrastructure such as roads, highways, airports, ports, schools, water and sewers; in non-physical capital such as training and education, health care, research and development and public information. High quality physical infrastructure and human resources both support private sector investments, directly contributing to productivity growth.

Canada's private sector has invested heavily in physical capital over the last two decades. Our private sector investment spending consistently rose faster than in all of the other G-7 countries, with the exception of Japan, from 1970 to 1989. By the late 1980s, total investment in physical capital in Canada reached almost 23 per cent of GDP; only Japan, at 36.7 per cent of GDP, had a significantly higher level. Through the 1970s and 1980s, the structure of investment in Canada shifted away from governments towards the private sector. By the late 1980s, growth in private-sector investment spending, particularly on machinery and equipment, was very strong.

However, the robust Canadian investment did not translate into equally strong productivity gains. Has investment been concentrated in the wrong sectors? Has investment in infrastructure been adequate? Or does the problem lie elsewhere, in Canada's performance in R&D and technology diffusion?

Canada's investment in research and development has been low by the standards of the main industrialized countries. In 1987, for example, Canada's proportionate spending on R&D was only half that in Germany, Japan and the United States, our main trading partners and we spent considerably less than smaller countries such as Switzerland, Sweden and the Netherlands.

Our private-sector R&D effort is particularly weak. Explanations include our resource-oriented industrial structure, a relatively high degree of foreign ownership and the small size of most Canadian firms. Nevertheless, a number of major Canadian industrial sectors perform substantially less R&D than their competitors abroad. Our R&D weakness may be hurting our productivity performance.

Enterprises can upgrade their technological capabilities by investing in their own research and development, and, if successful, create new products and services having an advantage in markets. Alternatively, firms can purchase technology directly or through licenses, joint ventures and so on. "Making or buying" technology are not strict substitutes for one another, however. The scale of a country's R&D effort itself can have an important influence on its propensity to innovate and adopt and exploit new technologies.

Technological innovation encompasses a much wider range of activities than just R&D. For example, a country can ensure wide diffusion of "best-practice" production technologies or the improvement of technology through licensing, joint ventures, transfers of personnel within multinational firms, or direct purchase of machinery and equipment from abroad. There is some evidence to suggest that Canadian firms may be slower to adopt new technologies than their counterparts in other industrialized countries. We need to better understand the process of technology diffusion in Canada if we are to improve our performance.

Better education and training

A highly educated and trained work force adapts rapidly to new situations, thrives on working with new technologies, and is capable of becoming more directly involved in promoting the success of the firm. A highly skilled work force will naturally develop a more direct stake in its own productivity performance.

Canada has traditionally emphasized universal education, and has made impressive progress towards this objective. The proportion of adults with a post-secondary or university diploma increased from only 7 per cent in 1961 to well over 30 per cent in 1986. Canada's spending on education as a percentage of GDP compares favourably with that of other G-7 countries.

Despite this spending, there are worrying signs that our education system may not have kept pace with the needs of a competitive economy in the 1990s. As many as 30 per cent of our high school graduates are unable to meet everyday reading demands. We have an alarming secondary school drop-out rate – almost 30 per cent – and for the most part these individuals are unable to go into high quality vocational training. Our young people need to have the education or training to continue to learn for the rest of their lives. Whether our secondary school system is in tune with the 1990s is by no means certain.

Canada lags behind in its vocational training effort. In recognition of the growing importance of a skilled labour force, the government has been shifting its training focus, through the Canadian Jobs Strategy and unemployment insurance reforms to achieve a better balance between passive support and active training for the unemployed. In April 1989, the government launched a major new initiative to increase its effort in the field of training. However, it will take time before the benefits of the Labour Force Development Strategy become apparent. Particular attention is being given to apprentice training for the young, which varies widely in quality across the country.

A particular concern is that Canada ranks near the bottom of the major industrialized countries in terms of private-sector training effort for the employed work force. In 1988, the average worker in Japan received 200 hours of training, in Sweden 170 hours, and in Canada less than seven hours.

This poor record is cause for serious concern because about two-thirds of those who will be working in the year 2005 are already in the labour force. With the continued rapid evolution of technology and global markets, failure to invest adequately in training for those already in the workforce would be a prescription for slow productivity growth.

Provincial and federal governments, industry, labour, and educators themselves all share a direct responsibility for education and training. These groups need to co-ordinate their efforts to ensure that the system in Canada is sufficiently well integrated to provide high quality, consistent life-cycle education and training. The recently announced Labour Force Development Board will bring together business, labour and other stakeholders to take the initiative in improving the nation's training efforts.

Better labour-management interaction

Even with the best technology and workforce skills in the world, our productivity performance would still depend fundamentally on how these are integrated in the work place. And that depends on management and workers.

Labour and management are increasingly working together to solve shop-floor problems. As work continues to evolve towards higher skill, non-repetitive tasks, there is greater need for innovation. Management and labour attitudes, working relationships, and compensation systems need to evolve to secure potential productivity gains which can then be distributed as higher real wages and improved profits.

Increasingly, firms are reporting strong productivity gains by combining more effectively their inputs – managerial, labour, capital – and by empowering workers to seek new, better ways of doing things on the shop floor. In this environment, labour develops a greater stake in the building of successful companies.

Collective bargaining systems are beginning to incorporate the growing responsibilities of workers. Innovative labour-management relations are increasingly based on more open communications about strategic issues including decisions on introduction of new technologies, improved training, employment security and profit sharing, adoption of continuous bargaining, and greater co-operation in the introduction of innovative production practices.

Labour and management are breaking new ground in establishing rules to govern the work place. This is a task essentially for the private sector. Nevertheless, questions arise as to whether governments should be doing more, through labour codes or other regulations, to encourage the process.

CREATING THE RIGHT BUSINESS FRAMEWORK

Improving the quality of capital, human resources and business-labour practices must go hand-in-hand with improvements in the broader business climate, which is the framework for private-sector decision-making. Governments set the rules that guide the operations of markets, through both domestic laws and international agreements. Experience shows that where these rules encourage efficiently functioning domestic markets for goods and services and open international markets, countries tend to become successful international competitors and to experience strong growth in living standards.

The Canadian economy in a globalized world

Canada has benefited enormously from the integration of world markets since the Second World War. While initially this liberalization focused on lower trade barriers, it has grown to include investment flows, services and technology. Secure access to international markets and opening the Canadian market to competition is critical to allowing Canadian firms to achieve world-class performance and to increasing productivity by capturing economies of scale and specialization.

The Canadian government has pursued these objectives through the Canada-U.S. Free Trade Agreement (FTA) and the current round of multilateral trade negotiations in the General Agreement on Tariffs and Trade (GATT), and will do so in the trilateral negotiations with Mexico and the United States on a North American Free Trade Agreement. Looking beyond the North American market, Canadians must consider how to seize emerging opportunities in the Pacific Rim, Europe and Latin America.

Inward and outward investment have become essential elements in the promotion of competitiveness. Companies seeking new export markets are finding that direct investment is often a preferred vehicle for establishing a presence in foreign markets; as well, direct investment is also increasingly used to secure access to new technologies. Inward investment is critical to the flow of technologies. Canada has made major progress in opening its door to foreign investment, both through the introduction of Investment Canada in 1985 and provisions in the Canada-U.S. FTA.

Improving international competitiveness increasingly turns on a firm's access to the best technologies in the world. The high costs and risks involved in investment R&D lead many firms to enter strategic R&D alliances and joint ventures. Canadian firms need to find ways to participate more fully in these international efforts and government must consider how the international regime might better promote the free flow of investment and technology.

The nature of international trade is changing rapidly. Canadian businesses need to be more aggressive in identifying new trends and opportunities and in moving quickly to take advantage of them. Government must ensure that the trade agenda responds to the priorities of the private sector.

Creating efficient and flexible domestic markets

Canada's domestic market, small by global standards, is still the seventh largest in the OECD. Interprovincial trade in goods and services is comparable to Canada's international trade. For Canadian firms to become internationally successful, the home market must be competitive.

Governments play a key role in establishing this market.

- They set the legal framework for markets with corporation law, bankruptcy law, competition policy and intellectual property law.
- They determine how freely goods, services and factors of production flow between provinces. They regulate key sectors of the economy such as labour markets, financial markets, and telecommunications.
- They create and regulate programs for broad social purposes, such as occupational health, safety, the environment, social security, regional development, education and training.

In doing these things, governments should ensure that the social benefits of any specific intervention clearly exceed its costs, and also be sensitive to the potential unintended interaction of policies directed at different objectives.

In Canada, the interaction of policies is complicated because federal and provincial governments share many responsibilities. Wherever they fail to harmonize policies, the result can be excessive regulatory burden and fragmented markets that disadvantage Canadian firms trying to become internationally competitive.

The Economic Council of Canada will focus directly on these issues in its study of the impact of governments on competitiveness. This comprehensive examination of the activities of government in Canada will assess how elements of policies related to revenues, expenditures, debt, and regulation affect Canada's ability to compete in international markets, and the implications for the prosperity of Canadians.

Ensuring Canada's tax system remains competitive

The competitiveness of a nation's tax system should be judged according to two fundamental criteria:

- the effectiveness of the system in raising revenues to fund the provision by government of important goods and services and to support a sound macroeconomic environment; and
- the ability of the system to raise revenues in ways that minimize interference with private decisions and the efficient operation of markets.

By these standards, the Canadian tax system as it had evolved by the mid-1980s impeded our competitiveness. High statutory tax rates and a narrow tax base reflected the many special incentives that had accumulated over the previous 15 years. But experience revealed them as inefficient and ineffective policy instruments. They led to sharp reductions in government revenues with little commensurate increase in economic activity. At the same time, they resulted in many profitable corporations not paying tax and undermined the ability of the tax system to raise revenues. The tax incentives also created substantial variations in tax burdens between different activities. This distorted the market signals that ought to be the basis of decisions by individuals and businesses.

Government reforms of the tax system have brought our income taxes more in line with those of other countries and have improved the structure of the major components of the system. Structural changes broadened the tax bases, lowered statutory tax rates, and minimized the use of distorting incentives.

The replacement of the antiquated and economically destructive Manufacturers' Sales Tax with the Goods and Services Tax (GST) was another major structural reform of Canada's tax system. The old federal sales tax raised the cost of business inputs and favoured the importation of goods into Canada over domestic production. At the same time, it hampered the ability of Canada's exporters to compete in world markets. In eliminating these problems, the GST is a key element of a more competitive tax system.

During tax reform, a number of incentives that enhance the overall competitiveness of the economy were retained. It will be necessary to continue to review the operation and targeting of these incentives and consider possible improvements. In particular, the government will be examining whether modifications to the R&D tax credit could ease its administration for taxpayers. It will also examine whether the tax system can be changed to remove potential impediments to the operation of capital markets in Canada. In this budget, the government is proposing measures to remove the tax-induced bias against pension funds investing in common equities in Canada.

In Canada, provincial governments independently determine their taxation policy and their policies directly affect our competitiveness. Harmonization of federal and provincial taxes is an important avenue to increased efficiency of the tax system. For example, the potential gains from sales tax reform would be increased substantially if provinces also adopted a harmonized sales tax structure. Quebec and Saskatchewan have already agreed to harmonize their systems and discussions with other provinces are proceeding.

TAKING UP THE CHALLENGES

The federal government does not have all the solutions for boosting the growth of our living standards. The strategies for success lie in the country's domestic and international framework policies, private-sector investment in science and technology and human resources, and in new thinking and action on labour and management organization in the work place. All of us must understand the issues and adopt new strategies to ensure our success.

The government plans to initiate in the spring a national dialogue to pursue the issues and questions Canadians must deal with in order to achieve rising standards of living into the 21st century. The objective must be to reach consensus on the solutions.

CHAPTER 8: SUPPLEMENTARY INFORMATION

TAX MEASURES FOR CANADIANS WITH DISABILITIES

The income tax initiatives proposed in this budget constitute one element of a broader strategy to promote equal opportunities for Canadians with disabilities. This overall strategy was announced last November by the Minister of State responsible for the Status of Disabled Persons.

These new tax measures build on a series of initiatives already undertaken to improve opportunities in the work place and to reduce the additional costs often faced by those with disabilities. For example, the government has:

- appointed a Minister responsible for the Status of Disabled Persons;
- passed the *Employment Equity Act* to promote hiring of Canadians with disabilities;
- broadened eligibility for the disability tax credit to include all Canadians with severe disabilities while increasing its value and providing for greater transferability to family members;
- expanded the list of items eligible for the medical expense tax credit to include disability-specific items that contribute to acquiring marketable skills and promote independence; and
- increased Canada Pension Plan (CPP) disability benefits by $1,800 per year so that the maximum disability pension is now $8,925.

In developing these initiatives, the government has benefited from the views of groups representing individuals with disabilities. The government will continue to work with these groups to improve the effectiveness of the tax system in meeting the needs of disabled Canadians.

The disability tax credit

The disability tax credit is provided to taxpayers who, as a result of a severe and prolonged impairment, are markedly restricted in their activities of daily living. The tax credit recognizes, in a general way, that Canadians with disabilities face higher costs of living and working. In 1989, the latest year for which data are available, there were some 355,000 individuals and their families who benefited from the disability tax credit and the total amount of this assistance was about $160 million.

To promote greater fairness, the disability tax credit will be increased by $125 from $575 to $700 as of the 1991 taxation year. This will increase federal assistance to disabled Canadians by $35 million per year.

As noted above, to claim the disability tax credit, a person's activities of daily living must be markedly restricted by reason of a physical or mental impairment. Currently, the terms "markedly restricted" and "activities of daily living" are not defined in the *Income Tax Act* but rather are set out in administrative guidelines published by Revenue Canada. The current guidelines will be included in the law so as to ensure greater fairness and uniformity in their interpretation and application.

The expression "markedly restricted" will continue to mean that, despite the use of medication, therapy, or devices, the effect of the impairment is to greatly restrict the performance of activities of daily living. In addition, the expression "activities of daily living" will continue to refer to basic functions such as seeing, hearing, speaking and walking, but not working or social, recreational and housekeeping activities. The codification of these definitions in the legislation does not change the existing eligibility criteria.

Medical expense tax credit

Part-time attendant care and three new disability-related expenses will be included in the medical expense tax credit.

Part-time attendant care

At present, attendant care expenses are eligible for the following tax assistance:

- a credit for the costs of a full-time attendant under the medical expense tax credit;
- a deduction of up to $5,000 for the costs of a part-time attendant required by a disabled worker;
- a deduction for the costs of child care in respect of a disabled child.

However, tax assistance is not currently available to those disabled taxpayers or their families who incur part-time attendant care expenses (including the costs of respite care) unless they relate to employment. These costs can impose a substantial financial burden.

In order to extend benefits to non-working disabled Canadians, up to $5,000 of part-time attendant care expenses which are not otherwise deductible in computing income will qualify for the medical expense tax credit. This provision will take effect for the 1991 and subsequent tax years. Eligible expenses will be those incurred after 1990 by, or on behalf of, a disabled person who qualifies for the disability tax credit in respect of an attendant who is not related to the disabled person. This new measure will assist families to care for disabled individuals at home and promote greater independence for disabled Canadians who wish to live on their own.

This change is expected to benefit 35,000 households at a cost of $20 million per year.

New expenses eligible for the tax credit

The list of eligible expenses is expanded from time to time as new medical expenses are identified. Three such expenses are to be included as eligible medical expenses, beginning in the 1991 taxation year:

- specially trained service animals that assist individuals with a severe and prolonged impairment which markedly restricts the use of their arms or legs;
- modifications to the home in order to enable a person with a severe and permanent mobility restriction (e.g., those with multiple sclerosis or cerebral palsy) to gain access to the home or rooms within it – this extends the existing provision which is available only to those confined to a wheelchair; and
- incontinence products such as catheters, catheter trays, and tubing required by reason of a physical impairment.

The estimated cost of these changes is $5 million per year.

Access and employment-related initiatives for disabled persons

Promoting access

Businesses often need to make modifications to their premises to accommodate disabled individuals – either customers or employees. Frequently, the costs of these modifications are substantial. Under the existing provisions of the *Income Tax Act*, when a business makes a substantive modification to a building, the costs may only be deducted for tax purposes over a lengthy period of time. Thus, it can take up to 40 years for these costs to be fully written off. To illustrate, if an employer installs ramps at a cost of $20,000 to accommodate an employee who is confined to a wheelchair then, assuming a rate of depreciation of 5 per cent, only 2.5 per cent (or $500) of the expense is now deductible in the year of installation.

The current provisions will be amended to allow businesses to fully deduct the costs of modifications to accommodate disabled persons in the year they are incurred. Thus, in the above example, the full $20,000 could be deducted in the year the ramps were installed. Eligible modifications will include interior and exterior ramps, hand-activated power door openers, alterations to bathrooms, as well as the widening of doorways to accommodate wheelchairs.

By improving access in this way, this measure will also promote more equal opportunities for disabled Canadians in the work force.

Disability-related employment benefits

Currently, where a disabled employee with a mobility or sight impairment receives employer-provided benefits such as subsidized parking, or allowances for taxis or specially designed public transportation (para-transport), these amounts are taxable in the hands of the employee. Furthermore, where the employer provides an allowance to a disabled employee for an attendant, this allowance is also considered a taxable benefit. These rules tend to discourage disabled Canadians from participating in the work force.

Allowances provided to employees for taxi fares, para-transport, and parking will no longer be considered as taxable benefits for those who are eligible for the disability tax credit by reason of a severe and prolonged mobility or sight impairment.

In addition, where an employer provides an allowance in respect of attendant care required to enable an employee who qualifies for the disability tax credit to perform employment duties (e.g., readers for the blind, signers for the deaf, coaches for the mentally handicapped), no taxable benefit will be imputed.

These changes – to promote access and make employment benefits non-taxable – will apply for the 1991 and subsequent taxation years. The estimated cost of these measures is $10 million per year.

Lump-sum CPP/QPP disability pensions

Recipients of Canada Pension Plan/Quebec Pension Plan disability pensions are taxed on these benefits in the year they are received, even though a portion of the benefit often relates to prior years. As a result, since the tax system is progressive, tax liabilities may be significantly higher than if the benefits had been paid and taxed on an ongoing basis from the date of eligibility.

This measure will reduce the tax liability of a recipient of a lump-sum payment of CPP/QPP benefits by spreading the amount over the years in respect of which they were paid.

This provision will apply to lump-sum CPP/QPP disability pensions received in the 1991 and subsequent taxation years.

TAXATION OF TOBACCO PRODUCTS

Excise tax increase

The excise tax on cigarettes will be increased by 3 cents per cigarette, effective February 27, 1991. The excise levies on other tobacco products will be increased proportionately. Thus, for example, the ad valorem excise tax on cigars will be increased from 40 to 65 per cent, and the excise tax on manufactured tobacco, including snuff, fine cut tobacco and pipe tobacco, by 2.04 cents per gram.

The budget also proposes to change the manner in which excise taxes and duties are imposed on tobacco sticks – preportioned rolls of tobacco which are inserted into paper tubes, in effect, to make high quality "roll-your-own" cigarettes. These products are currently taxed as a fine cut product on the basis of weight. However, because tobacco sticks generally weigh less than traditional roll-your-own cigarettes, they are less heavily taxed on a "per cigarette" basis. To equalize the tax treatment, effective February 27, 1991, the excise levies on preportioned tobacco sticks will be applied on a per unit basis at a rate of 5.4 cents per tobacco stick. As a result, tobacco sticks and other fine cut products will be taxed at approximately two-thirds of the rate on fully manufactured cigarettes.

Consistent with the treatment of remittances of income taxes, interest will be imposed on any delay in payment of the increases in taxes and duties on tobacco products beyond the time within which existing excise levies are normally remitted.

The tobacco product tax increases proposed in this budget will reinforce the government's National Strategy to Reduce Tobacco Use. This strategy is a comprehensive plan to address the problem of tobacco consumption in Canada. It includes a range of initiatives to prevent smoking, to promote public awareness of its health risks, to encourage cessation, and to facilitate crop substitution. Tobacco taxation plays an important role in this strategy – particularly in discouraging young people from starting to smoke. For instance, recent studies of the extent to which consumption of tobacco products is affected by increased prices suggest that a 10 per cent increase will reduce cigarette consumption by younger Canadians by as much as 14 per cent while consumption by adults will decline by between 4 and 9 per cent.

In 1984, per capita tobacco consumption in Canada exceeded consumption in the United States. Since that time, however, consumption of tobacco products has fallen at a faster rate in Canada than in the United States and Canadians are now smoking less on a per capita basis than Americans.

Per capita tobacco consumption of population

15 years and over (in kilograms)

	Canada	United States
1984	3.19	2.92
1985	3.08	2.91
1986	2.90	2.80
1987	2.78	2.68
1988	2.69	2.62
1989	2.48	2.48
1990[1]	2.34	2.39

[1] Estimate.

The more rapid decline in tobacco consumption in Canada is expected to continue, as the proposed 3-cent per cigarette tax increase will reinforce the government's past actions to curb the use of tobacco in Canada.

Treatment of tobacco product inventories

The excise taxes on tobacco products are imposed at the manufacturers level. When these taxes are increased in a budget, the new rates apply to any sales of tobacco products by manufacturers following the date on which the new rates become effective, usually budget night. However, wholesalers and retailers will have paid tax on the inventories they hold at the time of the budget, at the lower pre-budget tax rates. To ensure that the tobacco excise tax increases are applied in a consistent manner to all tobacco products at different trade levels, the increases proposed in this budget will apply to all wholesalers' inventories and to retailers' inventories of cigarettes exceeding 1,000 cartons.

Thus, inventories of cigarettes, tobacco sticks and fine cut tobacco products for roll-your-own cigarettes held by wholesalers and retailers as of February 27, 1991 will be subject to the excise tax increases of 3 cents per cigarette, 3.30 cents per tobacco stick and 2.04 cents per gram of fine cut tobacco announced in this budget. Vendors may use any convenient method for establishing their inventories of these products, including a physical count immediately following the budget, or an inventory taken for other purposes, either shortly before or after the budget, with appropriate adjustments to reflect sales and purchases in the intervening period.

In order to simplify compliance, the tax will not apply to tobacco products sold to consumers before midnight on February 26 or to the first 1,000 cartons or equivalent of tobacco products – any combination of cartons of 200 cigarettes or tobacco sticks, or 200 gram containers of fine cut tobacco – held in inventory in retail outlets at the end of business on that day. A threshold at this level will ensure that the tax on tobacco inventories will, for the most part, only apply to wholesalers and relatively large retailers. In addition, the tax increase will not apply to tobacco products held in vending machines at midnight on budget day. An extended period will be provided for remittance of the tax, allowing wholesalers and retailers to make payments in four equal monthly instalments, starting at the end of May of this year. Interest will apply to late or deficient instalments.

Vendors should contact their local office of Revenue Canada, Excise, for further information on the administration of this tax.

Revenue implications

Together these changes in the excise taxes on tobacco products and on inventories of these products will raise additional revenue of $1,400 million in the 1991-92 fiscal year, and $1,140 million, $1,030 million and $980 million respectively in the three subsequent fiscal years. The declining revenues reflect the continuing drop in consumption of tobacco products.

PROVINCIAL CAPITAL AND PAYROLL TAXES

In recent years, provinces have increasingly utilized capital and payroll taxes as sources of revenues from businesses. The imposition of these taxes raises two issues for the federal government:

- the payment of provincial payroll taxes by the federal government with respect to its employees; and
- the deductibility of provincial capital and payroll taxes from income subject to federal corporate income tax.

The Minister of Finance indicated to his provincial counterparts last year that these issues would be reviewed. In this budget, the government is announcing its intention to continue to pay voluntarily provincial payroll taxes of general application in respect of its employees and to limit deductibility of provincial payroll and capital taxes.

Payment of provincial payroll taxes

In February 1990, the federal government indicated that it would, on a voluntary basis, agree to pay provincial payroll taxes until the end of 1991, pending completion of a review of the issue. Currently, these taxes amount to some $230 million annually. The federal government is under no obligation to pay these taxes as the Crown is immune from taxation. However, in the interests of consistency with other employers, and in conjunction with the decision to limit their deductibility, the government has decided to continue to pay provincial payroll taxes on a voluntary basis.

Deductibility of provincial business taxes

Under the current system, certain provincial business taxes are deductible in computing a taxpayer's income while others are not. Currently, payroll and capital taxes are fully deductible in computing income while provincial income taxes are not deductible.

Deductible provincial taxes reduce a taxpayer's income subject to income tax, thereby reducing income taxes payable to the federal government. In effect, federal taxpayers across the country bear some of the burden of these deductible taxes no matter in which province they are levied. As a result, provinces have an incentive to use deductible provincial taxes rather than those that are non-deductible.

Over the past decade, provinces have made increasing use of these deductible taxes leading to a significant erosion of the federal income tax base. Currently, allowing these taxes to be deductible reduces federal tax revenue by about $700 million per year.

The federal government will act to limit the deductibility of such taxes. This will provide provinces with an unbiased choice between these alternative tax instruments. The provisions to give effect to this decision will be based on the following principles:

- the consistent treatment of payroll and capital taxes with income taxes and removal of the existing bias in favour of such deductible taxes;
- the insulation of small businesses from the effects of the change;
- the introduction of the measure over a period of time sufficient to allow businesses and provincial governments an opportunity to adjust to the new regime; and
- the generation of no additional revenue for the federal government.

In this budget, the government is setting out a mechanism to implement limited deductibility which is consistent with these general principles. This mechanism will be the subject of consultations with provincial governments.

The proposal has been structured to minimize the effect on taxpayers and provincial governments. Its basic design features are:

- a $10,000 annual cap on the amount of provincial payroll and capital taxes that may be deducted in computing income;
- an offsetting deduction from taxable income ("tax allowance") for qualifying taxpayers in lieu of general deductibility; and
- a gradual phase in over the next three years, with the new regime fully phased-in by January 1, 1994.

As a consequence of this design, there would be no increase in net federal revenues resulting from the proposal. The effect of limiting deductibility of payroll and capital taxes would be fully offset by the tax allowance. In addition, the $10,000 cap on the amount of deductible payroll and capital taxes would ensure that most small businesses were unaffected by the proposal. The transitional measures would reduce the number of corporations affected by the proposal in 1992 and 1993 and the size of the impact on income taxes payable of any affected corporations.

Details of the mechanism

a) Limiting deductibility

The amount of provincial payroll and capital taxes that a taxpayer could deduct would be limited to a maximum of $10,000. Such taxes paid in excess of this amount would not, after the transitional period, be deductible.

For the purpose of this proposal, payroll taxes would include any provincial tax imposed on a taxpayer and set by reference to the salary, wages, or other remuneration paid by the taxpayer; however, pension and workers' compensation contributions would not be affected. Capital taxes would include any tax imposed by a province and set, in whole or in part, by reference to a taxpayer's equity, liabilities, or assets (excluding real property taxes).

The $10,000 annual limit on deductibility would be shared between members of a corporate group. In other words, a corporation could deduct these taxes only to the extent that the total of such taxes payable by the corporation for a particular taxation year, as well as those deducted by other members of the group for taxation years ending in the same calender year, did not exceed $10,000.

Individuals and personal trusts would not be subject to this restriction and would continue to be able to deduct all of these taxes. Trusts, other than personal trusts, would be subject to the same limitations as corporations.

For members of a partnership, the treatment of these taxes would depend upon the status of the member. For those partners who are individuals, the taxes would continue to be fully deductible. Where the partners are corporations or trusts (other than personal trusts), the provincial taxes would be allocated to the partners and thus be subject to the $10,000 cap.

b) Offsetting tax allowance

The proposal would also provide a new deduction against taxable income. This tax allowance would be set at a rate such that limiting deductibility provides no net additional revenue for the federal government at current provincial capital and payroll tax levels.

The tax allowance, when fully phased-in, would be the amount by which 6 per cent of a corporation's taxable income exceeds a threshold of $10,000. The $10,000 threshold for the tax allowance reflects the fact that up to $10,000 of payroll and capital taxes would continue to be deductible in calculating corporate income.

The taxable income threshold would, like the $10,000 cap on provincial taxes, be shared among members of a corporate group. Each corporation's taxable income deduction would be limited to the amount by which 6 per cent of its taxable income exceeds the portion of the group's annual threshold allocated to that corporation, provided that:

- the total allowance claimed by all members of the group is not more than the amount by which 6 per cent of the group's taxable income exceeds $10,000; and
- the portion of the threshold that is allocated to any corporation in the group is not more than 6 per cent of its taxable income.

c) Transition period

The restrictions on deductibility would be implemented over the next three years, with the system fully phased-in on January 1, 1994. During this transitional period, the deductible portion of payroll and capital taxes over $10,000 would be reduced, while the rate of the tax allowance would be increased accordingly.

For the 1992 calendar year, corporations and commercial trusts would be permitted to deduct two-thirds of provincial capital and payroll taxes without limitation; in addition, the lesser of one-third of such taxes and $10,000 may also be deducted. The tax allowance would be the amount by which 2 per cent of taxable income exceeds $10,000.

In 1993, such taxpayers would be permitted to deduct the sum of: one-third of provincial payroll and capital taxes and the lesser of two-thirds of such taxes and $10,000. The tax allowance would be the amount by which 4 per cent of taxable income exceeds $10,000.

In 1994 and subsequent years, taxpayers would be able to deduct the lesser of $10,000 and the provincial payroll and capital taxes actually paid. The tax allowance would be calculated as the amount by which 6 per cent of taxable income exceeds $10,000.

Illustrative example

Consider a corporation currently in the following situation:

Taxable income	$1,000,000
Combined payroll and capital taxes	63,200

Calculation of taxable income under this proposal:

	Taxable income before proposal	$1,000,000
plus:	**Non-deductible taxes** ($63,200 – $10,000)	$53,200
equals:	**Taxable income before allowance**	$1,053,200
minus:	**Allowance** ((0.06 x $1,053,200) – $10,000)	$53,200
equals:	**New taxable income**	$1,000,000

Federal tax before proposal (.28 x $1,000,000)	$280,000
Federal tax after proposal (.28 x $1,000,000)	$280,000
Net effect	0

Note: This example illustrates the proposal by considering a hypothetical corporation where there is no net effect. Clearly, the net effect would vary for different corporations. For example, if the level of payroll and capital taxes were $53,200, the corporation would pay $2,600 less federal tax. If the payroll and capital taxes totalled $73,200, the corporation would pay $2,600 more federal tax.

PENSION FUNDS: PROMOTING EQUITY INVESTMENT

Substantial pools of retirement savings of Canadian individuals are held and invested by large pension funds. Pension funds, however, face a different set of investment incentives and constraints than do the individuals on whose behalf they make investments. These differences distort the investment decisions of pension funds relative to those that would have been made directly by individuals. These differences relate to both the taxation environment for pension funds relative to individuals, and regulations applying to investment behaviour by pension funds. These differences are important given the size of these funds. In 1989, the market value of assets held in pension funds exceeded $190 billion.

To encourage Canadians to establish a secure and adequate source of retirement income, income in pension funds is allowed to accumulate free of any tax – both employees and employers receive a deduction from income for contributions into the fund, no tax is paid on the income as it is earned in the fund, and the beneficiary includes any withdrawal from the fund in income subject to tax. The tax-free nature of income accruing within a pension fund results in a different relative treatment of returns to debt and equity investments when compared to savings held directly by individuals.

Several tax provisions increase the after-tax return to equity investments held directly by individuals relative to debt. These include the dividend tax credit, the capital gains exemption, the tax deferral on accrued but unrealized gains, as well as the inclusion of only 75 per cent of realized capital gains into income. These incentives to invest in equity do not apply to income on savings of Canadians held in pension funds. Consequently, pension funds, as intermediaries, face different market signals with respect to relative returns to debt and equity than do individuals investing directly.

The following simple example illustrates the different signals faced by individual investors and pension funds when assessing their investment portfolios.

Illustrative example: Impact of the tax system on equity and debt investments earning a 10 per cent before tax return

	Investments held by		
	Individuals		Pension funds
	Before tax	After tax[1]	Before and after tax
Equity	10.0[2]	8.0	10.0
Debt	10.0	6.2	10.0

[1] Reflects average tax paid by individuals on these types of investments.

[2] An illustrative rate of return of 10 per cent for each type of investment is assumed in order to isolate the impact of the tax system.

For purposes of illustration, both the equity investment and debt investment are assumed to earn a before-tax rate of return of 10 per cent. The table shows the after-tax return that would accrue to both types of investments for an individual and a pension fund in such circumstances.

In this case, the individual receives a premium of 1.8 percentage points for investing in equity. The pension fund, however, receives the same rate of return on either investment and would tend to choose the less risky debt investment.

Government regulations also affect the investment decisions of pension funds. Regulatory restrictions under the *Pension Benefits Standards Act* (PBSA) constrain pension funds subject to this Act (or similar provincial Acts) from investing in any corporation that does not meet a five-year earnings or dividends test. This reduces the number of eligible equity investments for these funds.

In addition to the above factors, the investment decisions of pension funds are affected by other important factors, including the size and potential for diversification in the Canadian equity markets, the liability structure of pension plans, and investment restrictions imposed by provincial governments. Many pension funds do invest a significant proportion of their assets in equity because pension fund managers recognize the increased return that investments in equity can generate over a longer time horizon. However, the relative level of investment in equity markets by pension funds is less in Canada than in the United States or the United Kingdom. Equity investments of private sector funds amount to about 36 per cent of their assets in Canada as compared to 46 per cent in the U.S. and 55 per cent in the U.K.

Proposal for discussion

The differential in market signals faced by pension funds raises the concern that they may make lower levels of investments in equities than otherwise. Since pension funds control such a large asset base, this may make Canadian business less competitive. Lower equity investment by pension funds could reduce overall domestic demand for equities. Depending upon a firm's access to international capital markets this could raise the cost of equity financing, and increase the reliance of some Canadian corporations on debt. Higher debt obligations can have the effect of weakening the corporate sector. A number of commentators including the National Advisory Board on Science and Technology have recognized the important role pension funds play in Canadian capital markets and have been recommending changes to facilitate equity investment by pension funds.

The government's proposal would encourage pension funds to further invest in Canadian equity markets by making changes to the tax environment faced by pension plans. The goal of these changes would be to bring the market signals faced by pension funds in choosing between debt and equity investments more into line with the signals faced by individuals. At the same time, the federal regulatory restrictions faced by some pension funds in their choice of equity investments would be reduced. These changes would reduce the distortions in pension fund investment behaviour and thereby encourage pension funds to invest in equity markets.

Proposed mechanism

The government proposes, as a basis for consultation, to put forward a measure calling for a combination of a credit and levy to be applied to holdings of Canadian common equity and other investments respectively. The credit would increase the return to the eligible equity investments held by pension funds and the levy would decrease the return to other investments. For example, a one-per-cent credit could be provided to the average market value holdings of common equity investments in Canadian corporations and a one-half per cent levy could be applied to the average market value of other investments. The credit would be used to offset any levy payable. Any excess of credits over levies in a year would not be paid out to pension funds but would, however, be allowed as a carryover to other years. The carryover would compensate for liabilities arising from fluctuations in market values of investments in a particular year.

The following table shows the illustrative impact of such a combination of credits and levies on the investment choices of a pension fund. Following such a change, many pension funds would face a differential of 1.5 percentage points in the return to equity versus the return to debt thereby bringing the relative returns to equity versus debt more into line with the situation faced by an individual.

Impact of illustrative credit/levy mechanism on relative returns to pension plans

	Before tax return	Tax	After tax return
Individuals			
Equity	10.0	(2.0)	8.0
Debt	10.0	(3.8)	6.2

	Before tax return	Credit/(levy)	After tax return
Pension funds			
(Illustrative impact)			
Equity	10.0	1.0	11.0
Debt	10.0	(0.5)	9.5

A transition period to any such new structure should be provided to allow pension funds time to modify their investment decisions in response to this new mechanism. The transition period would also take into consideration the size of the equity market in Canada and the ability of the Canadian corporate sector to respond to the increased demand for Canadian equities that would result from this measure.

In order to reduce any administrative burden and in recognition of the special circumstances faced by some smaller funds, any new measures would only apply to assets of a pension fund in excess of a threshold amount. The measures would apply only to registered pension funds and would not apply to funds held in registered retirement savings plans.

The government is also proposing to modify the regulatory environment faced by pension funds subject to the PBSA by adopting a prudent portfolio approach to investment selection as discussed in its 1987 paper, "New Directions for the Financial Sector". This change would allow pension funds to choose equity investments from a larger group of Canadian corporations and thereby assist the potential increase in equity investment resulting from this tax change. The prudent portfolio approach has been adopted by the Ontario and Quebec governments in the re-regulation of funds under their jurisdiction. The changes to the PBSA rules will be made as part of the overall changes to the investment rules governing insurance companies and trust and loan companies.

Next steps

The government recognizes that the proposal represents a major change for both pension funds and the Canadian capital market. As a result, extensive consultations will be undertaken with associations representing pension plan sponsors, the investment community, and pension fund managers prior to legislating any changes. This will provide a full opportunity for these groups to discuss both the broad goals of the proposal and its technical details. To provide a basis for these consultations, the government will issue a technical discussion paper this spring.

SMALL BUSINESS CORPORATIONS: GOING PUBLIC

In recognition of the contribution of the small business sector to job creation and innovation, the federal government provides an enhanced lifetime capital gains exemption of $500,000 for gains realized by individuals on the disposition of qualified small business corporation shares. The enhanced exemption encourages investment, risk-taking and broader individual participation in the equity of Canadian-controlled private corporations, which face more difficulty in attracting capital than larger, public corporations.

In order to benefit from the enhanced exemption, the corporation must be a small business corporation, as defined in the Income Tax Act, at the time that the shareholder disposes of his or her shares in the corporation. Shares of a public corporation do not qualify as small business corporation shares. Concerns have been expressed that this condition may be an impediment to firms that seek to go public by having their shares listed on a prescribed stock exchange in Canada. In particular, once the small business corporation has gone public, its shareholders lose the $500,000 exemption on their shares of the corporation with respect to gains accrued while the corporation qualified. The alternative of disposing of the shares prior to the initial public offering may be unacceptable to the shareholders who wish to continue to participate in the growth of the corporation.

The new provision will apply to individuals for the 1991 and subsequent taxation years and will be elective in nature. If the individual so elects, he or she will be treated as having disposed of all shares of a class of the capital stock of the small business corporation immediately before it becomes a public corporation. Where the election is made, the taxpayer must also specify the proceeds of disposition of the shares. The specified proceeds may be the adjusted cost base of the shares or any higher amount up to their fair market value at that time. The individual will thus be able to control the amount of the taxable capital gain in respect of the elected disposition brought into income at that time, and can match that gain to the availability of his or her capital gains exemption. Where the election is made, the taxpayer will be treated as having reacquired the shares immediately after the elected disposition at a cost equal to the specified proceeds.

NOTICE OF WAYS AND MEANS MOTION TO AMEND THE INCOME TAX ACT

That it is expedient to amend the Income Tax Act and to provide among other things:

Disability tax credit

(1) That, for the 1991 and subsequent taxation years, the provisions of the Act relating to the disability tax credit be amended

(a) to increase the amount of the credit from $575 to $700 for 1991 (increased by the indexing factor for subsequent years), and

(b) to clarify that, for the purposes of the credit, an individual is to be considered markedly restricted in his or her activities of daily living only where, even with the use of appropriate devices, medication or therapy, the individual is blind or is generally unable (or requires an inordinate amount of time) to feed and dress himself or herself or perform fundamental functions such as:

(i) cognitive functions;

(ii) speaking so as to be understood, in a quiet setting, by another person familiar with the individual;

(iii) hearing so as to understand, in a quiet setting, another person familiar with the individual;

(iv) controlling bowel or bladder elimination functions; and

(v) walking.

Medical expenses

(2) That, for the 1991 and subsequent taxation years, the following unreimbursed expenses incurred after 1990 qualify as eligible medical expenses for the purposes of the medical expense tax credit:

(a) the remuneration paid for the care of an individual who has a severe and prolonged mental or physical impairment to a part-time attendant (other than a person under 18 years of age or that is related to the individual), to the extent that it does not exceed $5,000 and is not otherwise deducted in computing a taxpayer's income or does not otherwise qualify for a tax credit for the year or any other taxation year,

(b) the cost of an animal trained to assist an individual who has a severe and prolonged physical impairment, where the animal is provided by an organization one of the main purposes of which is the training of such animals, and the cost for the care and maintenance of such an animal, including food and veterinarian care,

(c) the cost of incontinence products required by reason of an individual's physical impairment, and

(d) reasonable expenses relating to modifications to the home of an individual who has a severe and prolonged mobility impairment to enable the individual to gain access to, and be mobile within, the home.

Employment benefits

(3) That, for the 1991 and subsequent taxation years, no amount be included in computing an individual's income from an office or employment with respect to reasonable amounts paid or benefits provided by an employer to the individual that relate to

(a) transportation (including parking) of the individual for commuting between the individual's home and work location where the individual is blind or has a severe and prolonged mobility impairment, or

(b) an attendant to assist the individual in the performance of the individual's employment duties where the individual has a severe and prolonged mental or physical impairment.

Modifications to buildings to accommodate disabled persons

(4) That costs incurred after 1990 of eligible disability-related modifications to a taxpayer's building used in earning income from a business or property be deductible in computing the taxpayer's income and, for this purpose, "eligible disability-related modifications" means the installation of hand-activated power door openers and interior and exterior ramps, the widening of doorways and necessary modifications to bathrooms to accommodate wheelchairs.

CPP/QPP lump-sum disability payments

(5) That an individual (other than a trust) who, in a particular taxation year after 1990, receives disability benefits under the Canada or Quebec Pension Plan be entitled to elect to exclude from the individual's income for the particular year that portion of those benefits that relates to an earlier taxation year, in which event the individual's tax otherwise payable for the particular year shall be increased by any additional tax that would have been payable by the individual for the earlier year had such benefits relating to the earlier year been included in computing the individual's income for the earlier year.

Small business corporations: going public

(6) That, for the 1991 and subsequent taxation years, an individual be permitted to elect

(a) to have disposed of capital property that is shares of a class of the capital stock of a small business corporation immediately before the time it becomes a public corporation by reason of the listing of a class of its shares on a prescribed stock exchange in Canada for proceeds of disposition specified by the individual equal to their adjusted cost base or such higher amount as does not exceed their fair market value, and

(b) to have reacquired such shares immediately after that time at a cost equal to those proceeds.

NOTICE OF WAYS AND MEANS MOTION RESPECTING AMENDMENTS TO THE EXCISE ACT AND THE EXCISE TAX ACT

That it is expedient

I. To amend the Excise Act to provide among other things:

Tobacco sticks

1. That tobacco sticks be added as a separate category of manufactured tobacco product and defined to mean every description of any roll or tubular construction of tobacco intended for smoking, other than a cigar, that requires further preparation to be consumed, and, where any tobacco stick exceeds 90 millimetres in length or 800 milligrams in weight, each 60 millimetres or 650 milligrams, as the case may be, or fraction thereof, be deemed to be a separate tobacco stick.

Excise duty rates

2. That excise duty on tobacco sticks be imposed at the rate of $18.333 per thousand.

3. That the excise duty on cigars be increased to $14.786 per thousand.

4. That the excise duty on Canadian raw leaf tobacco, when sold for consumption, be increased to $1.572 per kilogram actual mass.

Effective dates

5. That any enactment founded on paragraphs 1 to 4 of this motion be effective on and after February 27, 1991.

II. To amend the Excise Tax Act to provide among other things:

Excise tax rates

6. That the excise taxes on tobacco products be imposed at the following rates:

(a) on each five cigarettes or fraction of five cigarettes contained in any package, $0.25888;

(b) on each tobacco stick, $0.03565;

(c) on manufactured tobacco, including snuff, but not including cigars, cigarettes and tobacco sticks, $35.648 per kilogram; and

(d) on cigars, 65 per cent.

Tobacco products inventory tax

7. That a tax be imposed on excise tax-paid cigarettes, tobacco sticks, and loose, fine-cut manufactured tobacco for use in making roll-your-own cigarettes (loose tobacco), in the inventory of a person as of the beginning of February 27, 1991, at the rates of

(a) 3 cents for each cigarette,

(b) 3.3 cents for each tobacco stick, and

(c) 2.04 cents for each gram of loose tobacco,

payable by the person who owns the tobacco at that time.

8. That the tax imposed pursuant to any enactment founded on paragraph 7 of this motion in respect of a person's inventory of tax-paid tobacco held at the beginning of February 27, 1991 at a separate retail establishment of the person be payable only on the quantity of tax-paid tobacco in that inventory in excess of 200,000 units.

9. That every person required to pay the tax imposed pursuant to any enactment founded on paragraph 7 of this motion be required to determine the person's inventory of tax-paid tobacco as of the beginning of February 27, 1991 by taking a physical count of the inventory or by such other means as would permit the determination of the inventory as of that time.

10. That, on or before May 31, 1991, every person required to pay the tax imposed pursuant to any enactment founded on paragraph 7 of this motion be required to file with the Minister of National Revenue a return in a manner and form and containing such information as the Minister may prescribe and that the filing of separate returns in respect of the inventory of separate branches or divisions be authorized for persons authorized to file separate returns under Part IX of the Act in relation to those branches or divisions.

11. That every person required to pay the tax imposed pursuant to any enactment founded on paragraph 7 of this motion be required to remit that tax to the Receiver General in four equal instalments, payable not later than the last day of May, June, July and August of 1991.

12. That where the tax imposed pursuant to any enactment founded on paragraph 7 of this motion is not remitted or only partially remitted within the time specified in any enactment founded on paragraph 11 of this motion, interest at the rate prescribed for purposes of the Act be imposed on the amount of the deficiency in the remittance, for the period from the first day following the day on or before which the amount would have been required to have been remitted had the enactments been assented to on February 27, 1991 to the day on which the amount is remitted.

13. That a penalty at the rate of 6 per cent per year be imposed on late or deficient remittances of the tax imposed pursuant to any enactment founded on paragraph 7 of this motion, for the period commencing on the later of the second day following the day on which the enactment is assented to and the first day following the day specified for remittance of the amount and ending on the day on which the amount is remitted.

14. That authority be provided for the Minister to grant an extension of the time for paying the tax imposed pursuant to any enactment founded on paragraph 7 of this motion or filing a return in respect of that tax and, where the time is so extended, interest accrue as if the time had not been so extended and penalty be payable only from the expiration of the time so extended, and that the provisions of section 280 of the Act relating to the waiver of any interest or penalty be extended to apply, with such modifications as the circumstances require, in respect of that tax.

15. That the provisions of sections 68.17 and 68.19 of the Act relating to the payment of an amount equal to the amount of the excise tax imposed under section 23 of the Act in respect of goods sold for use as ships' stores and for certain uses by Her Majesty in right of a province which has not entered into a reciprocal taxation agreement, be extended to apply, with such modifications as the circumstances require, in respect of the tax imposed pursuant to any enactment founded on paragraph 7 of this motion.

16. That the provisions of section 70 of the Act relating to drawbacks of the excise tax imposed under section 23 of the Act be extended to apply, with such modifications as the circumstances require, in respect of the tax imposed pursuant to any enactment founded on paragraph 7 of this motion.

17. That, for purposes of any enactment founded on this paragraph and paragraphs 7 to 16 of this motion,

(a) "inventory" of a person at any time be defined as goods that, at that time, are owned by the person and are for sale in the course of a business of the person but not including goods that are held at that time in vending machines;

(b) "separate retail establishment" of a person be defined as a shop or store of the person

(i) at which, in the ordinary course of the person's business, the person regularly sells tobacco products, otherwise than through vending machines, to consumers attending at the shop or store,

(ii) that has a geographical location separate from other places of business of the person, and

(iii) in respect of which separate records, books of account and accounting systems are maintained;

(c) "tax-paid tobacco" be defined as cigarettes, tobacco sticks, and loose, fine-cut manufactured tobacco for use in making roll-your-own cigarettes, in respect of which excise tax imposed under section 23 of the Act became payable before February 27, 1991; and

(d) "unit", in respect of tax-paid tobacco, be defined as one cigarette or tobacco stick and one gram of loose tobacco.

Effective dates

18. That any enactment founded on paragraphs 6 to 12 and 14 to 17 of this motion be effective on and after February 27, 1991.

and,

III. To provide among other things:

Application of interest to excise duty increase

19. That interest be imposed on any increase in the amount of excise duty payable on tobacco products pursuant to any enactment founded on paragraphs 1 to 4 of this motion, or any increase in the amount of additional customs duties payable on tobacco products as a result of any enactment founded on paragraphs 1 to 4 of this motion, that is not remitted within the time that it would have been required to have been remitted had that enactment been assented to on February 27, 1991, calculated at the rate prescribed for purposes of the Customs Act, in the case of imported tobacco products, and at the rate prescribed for purposes of the Excise Act in any other case.

Application of interest to excise tax increase

20. That interest be imposed on any increase in the amount of excise tax payable on tobacco products pursuant to any enactment founded on paragraph 6 of this motion that is not remitted within the time that it would have been required to have been remitted had that enactment been assented to on February 27, 1991, calculated at the rate prescribed for purposes of the Customs Act, in the case of imported tobacco products, and at the rate prescribed for purposes of the Excise Tax Act in any other case.